EXITING AN IFA FIRM THROUGH INTERNAL SUCCESSION

Or how to retire from your firm with a lump sum in your pocket, safe in the knowledge your firm will carry on in the hands of trusted colleagues and your clients won't be shoehorned into some Consolidator's proposition and fee structure.

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1. Introduction

Accountants & Solicitors have been building firms which have enabled Retiring Principals to come in and to go out on retirement with a lump sum for hundreds of years. They have been facilitating this whilst at the same time enabling their firms and their service to evolve and move with the time. They have achieved it without causing any disruption at all to their client service and whilst maintain job security and pleasant working environments for their staff.

On the other hand, when most Principals of Independent Financial Advice firms get towards retirement most of them seem to think their only option is to sell their client base to a Consolidator.

If they do sell to a Consolidator the Retiring Principal should receive a lump sum. But they will also lose all influence and control over the way service their clients receive in future, the investment proposition which they will be offered and the fees which they will be charged. The job security and future career prospects of their staff, and the working practices which they are required to observe, will be under the control of the Consolidator. Eventually the firm will lose its separate identity and it will cease to exist.

My first career was Accountancy. After qualifying in that profession, I became a Financial Adviser in the late 1980's at a time when the concept of Independent Financial Advice did not exist, and the market was dominated by a few very large organisations which distributed their products and investments through their own captive sales forces.

The quality of many of those products was very questionable and the charges which applied to some of them were often very difficult to work out and very high. The "financial advisers" who operated in this environment were very simply salespeople who earned their living by selling their organisation's products and investments, mostly on a commission only basis. Pretty obviously there was little incentive for the organisations involved to improve product quality or reduce charges, the salespeople probably didn't worry to much about what they were selling as long as they were able to convince people to buy it.

Consequently, the Financial Services Act 1986, which actually came into force in April 1988, introduced regulation of Financial Products and Financial Advice for very good reasons.

As far as Financial Advice was concerned, this Act also required Advisers to obtain a very basic level of professional qualification and it introduced a polarisation regime which required Financial Advisers to either be "Tied" to a single organisation, meaning they would represent only that organisation and could recommend only it's products or investments, or to become an "Independent Practitioner" meaning they would represent their client and be required to implement their advice by recommend the most suitable product or investment they could identify from all those available in the market.

This new regime was the catalyst for my entry into Financial Advice. As a Chartered Accountant I had been referring clients to "Financial Advisers" for several years and I had become increasingly interested in the concept of personal financial advice. I had though been trained over several years to recognise that my "product" was my technical knowledge, my experience and to some extent I guess my personality, and the way I charged for my advice was to charge a straightforward ad transparent fee so that the client knew exactly what they were paying, and they could judge that they were receiving value for money.

That training instilled in me what I would describe as a very professional approach, the essence of which was that my role as an adviser was to act only for my client in accordance with their instructions, to ensure I never let any conflict of interest arise to ensure and above all to ensure my advice was always in their best interest and that my thinking was not influenced by any other factor.

I could not reconcile my vision of what professional advice should look like with the concept of commission based tied advice. The concept of Independent Financial Advice gave me hope that I could apply the same concepts of professional advice I had been taught as a Chartered Accountant to a new career as a Financial Adviser so that was why I jumped over the fence and become one.

As I look back on a 9 year career as a practising Chartered Accountant and a 30 year plus career in financial advice, I reflect on the massive increase in regulation I have seen. My fear is now that that it is the Compliance Officers of many firms who now formulate the advice, rather than the Advisers who are actually qualified to give it. Another key theme is that the base level qualification has got a lot harder, although it is still nowhere near demanding as those which Chartered Accountants and Solicitors have to pass. Additional qualifications are available and some of those are perhaps now on a par.

But regulation and qualifications are not enough, in my view, to create or sustain a profession. I fear that the march of Consolidation over the last few years is taking out embryonic profession round full circle and back to the bad old days of the 1980's. It seems clear to me that, if Consolidation continues much further, the market for financial advice will once again be dominated by a few, very large organisations which offer a limited range of products and investments and take them to market by their own internal sales forces. There will be no pressure on those organisations to improve quality and cost and conflicts of interest will again abound.

This is why I am passionate about sustaining a proper Independent Financial Planning profession. I believe the foundation of that has to be Independent status. I don't mean though in the FCA sense which bizarrely allows a financial advice firm to describe itself as IFA even if it is owned by an investment manager, I mean Independent in a common sense, truly conflict free sense of the word.

So, when my Business Partner and I combined our firms in 2017, one of our key principles was that our retirement would not involve selling out to any external organisation. Our intention instead was to build a truly Independent firm by inviting colleagues into equity and growing it to the extent that it could facilitate our retirement at the required point, without any disruption to clients or staff, and so that our exits could be financed at least to some extent from internal resources, thereby reducing any dependence on external debt finance as far as we could.

I am retiring from that firm next year on exactly these terms. The Heads of Terms has been signed, the finance is arranged in principle, all we are waiting for is HM Revenue & Customs Clearance as to the tax treatment involved and we will be applying for that by the end of the year.

My aim in writing this Guide is to share the benefit of my experience with others IFA principals who are attracted to the concept of Internal Succession and are wondering how to go about it.

For the sake of simplicity, I use the generic terms "Firm" to describe the Financial Advice business involved, "Retiring Principal" to refer to the person who is aiming to retire and sell their interest, and "Internal Successor" to refer to the person or persons who acquire it. These terms have universal application, the size and structure of the firm is irrelevant as are the number of people involved.

I have also, added in the Appendix some further detail about how we approached Internal Succession within my own firm, Centurion Chartered Financial Planners in the hope it adds further useful context, explanation and a bit of practical help.

2. The Concept of Internal Succession

An Internal Succession (IS) is the term commonly used to describe a transaction whereby an owner or shareholder of a firm exits by transferring ownership of it to people who already work for the firm probably, but not necessarily, in exchange for a cash sum.

IS therefore describes a concept and there are, broadly, two ways it can be achieved. The first is an Employee Ownership Trust (EOT), the other is a transfer of ownership to specific colleagues which, for the purposes of this Guide we will call a Management Buyout (MBO).

Both options are outlined below and the right one will depend upon the specific objectives of the parties involved and probably upon the structure and personnel who work within the particular firm involved.

The ownership involved need not be entire, it could relate to just a partial share of the firm, except that if an EOT is the intended route to IS a majority interest must be transferred in a single event. If that is not feasible that particular option will not be available.

Where a firm already has multiple owners, it is probably unlikely in the case of an IS that they will all wish to exit at the same time. In this case it is perfectly feasible that ownership is transferred in stages over a period of time. Bear in mind though, that given the nature of an IS and the factors involve, a successful IS will almost certainly require time, even if the firm only has one owner and one successor.

The constitution of the firm involved is theoretically irrelevant in the case of an MBO, the concept applies whether the firm is currently operating as a sole trader, a Partnership, a Limited Liability Partnership, or a Limited Company. But it is worth pointing out though that the structure of the firm involved can affect exactly how the transaction itself is arranged. However, if the firm not currently structured as a company, it would need to be so in order to implement an EOT. It might also be necessary from a funding perspective, or be it might be advisable from other perspectives, to convert it into one before going down the route of an MBO.

As long as the firm is well established and has a sound financial foundation, its business model, the service it offers, the type of client it advises, how it sources those clients and the way it calculates and charges its fees are all irrelevant. An IS can succeed however a firm operates from those perspectives regardless of whether it is affected through either an EOT or an MBO.

IS will certainly not a route that every Retiring Principal will want to take, and even if where it is their preference, an IS may not always be feasible.

Where it is feasible, though, an IS, no matter how it is affected, will provide an ideal exit route for a Retiring Principal who feels strongly that they want to:

1. Enable the firm they have built to carry on Independently and in what they perceive to be "safe hands" which fully understand the firm, the services it provides, the clients it provides those services to and the culture that it operates within when doing that.

2. Reward and incentivise the key people who have helped them build that firm and who they view as being intrinsically important to its future sustainability, and hopefully its future growth.

3. Perpetuate the firms service, proposition and fee structure and protect clients from being transferred into a whatever financial advice service and investment proposition an external purchaser may ultimately decide to offer them, at whatever fees they may ultimately decide to charge.

Obviously, an IS cannot guarantee the successor owners won't change fees, service or culture, but what it will do is at least ensure future decisions are made by people who have grown up within the structure and culture the previous owner has established. Assuming the firm is operating reasonably efficiently and profitably there is probably little direct incentive for that successor to make any material changes. If anything their minds are likely to be entirely focused on ensuring a smooth transition and it is therefore unlikely they will change very much or do it very soon. Arguably it could be foolish of them to change anything given the potential disruption it could cause.

An IS will be particularly appropriate where the Retiring Principal feels the above objectives are more important than the value of any capital sum they receive on exit. It may not necessarily be the case they will receive any less through an IS than they might in an external sale, but if they are prepared to subordinate the value of what they ultimately receive this could make an IS a lot more attractive to their successors, or indeed also make an IS more feasible than it might otherwise have been.

Compared to an external sale, by which I mean a sale to a party who is not currently connected to the firm, the IS route offers some significant potential advantages for all the stakeholders involved in the firm as it currently stands. For example:

- Most obviously, an IS should facilitate a smooth transition of ownership from the current owner to the new owners with minimal, and potentially without any, disruption for clients or other staff members.

- The clients and staff are therefore likely to be very much reassured that the firm will carry on "business as usual" going forwards but with the added assurance that the new owners will be involved for a lot longer time horizon than the old one was going to be. Hopefully any uncertainty they may have had, has instantly been removed.

- There is less likely to be any change of personnel within the firm. Obviously financial advice is very much a people business and clients can forge very close professional relationships with those who advise them, and vice versa. An external buyer will be very aware of this and is likely to avoid changes to personnel at least in the short term. On the other hand, a transfer of ownership to a third party is much more likely to result in changes to working practices. Arguably given the FCA's Consumer Duty regime an external sale probably now means considerable change is pretty much inevitable. The expectation of change might well then lead on to key personnel deciding to leave. In an IS situation, as long as the staff have confidence in the colleagues who have taken on ownership and control, such problems are probably very much less likely to arise. Obviously, though, the key is ensuring that confidence does exist and that it is well founded, so the IS plan must therefore take this into account and make sure that all parties are instilled with confidence. It is imperative that the succession is built on very solid foundations before the handover is formally completed.

- Similarly, it is also less likely there will be any significant changes to existing working practices, systems, and processes, for example to terms of business, fee structures, investment propositions or administration platforms. In turn, avoiding changes to these business fundamentals will also avoid any need to re-train, to build new third-party relationships and any need to explain the changes to clients, to obtain their buy in and agreement to them and to deal with any compliance aspects that may be involved in effecting such changes. Avoiding all that will very definitely also avoid additional costs being incurred, it will also not divert staff away from the key priority, which is obviously giving advice, keeping clients happy and earning fees.

- Since the new owners already know and work for the firm, and they should be highly motivated by their new ownership, the transition should secure their long term commitment and, assuming they have the required skills and attributes, the long term future of the firm.

- IS will though obviously refresh the management of the firm. So if the new management do not possess the necessary skills and attributes required to manage it this could be more of a threat than an opportunity. So an integral part of completing a successful IS will be to ensure that the successors do have all the attributes and skills required or that they have covered any that are missing by other means. The result of an IS should be that management is reenergised and is looking forward to the future with a very clear plan as to how they will sustain and grow the firm going forwards, and with all bases covered.

- Compared to an external sale, an IS very significantly reduces the need to share information about the firm' situation and plans with external third parties. Obviously, if an External Succession was going to be pursued all parties would sensibly be bound by Non Disclosure Agreements at a very stage but an IS, because all parties are currently working within the firm will significantly reduce the risk that confidential information will be seen, or abused, by any third party, particularly a potentially competing business.

- Another factor is that, because all key parties are already working within the firm, it should be very much easier to share information and conduct any discussions and negotiations which are required than in an external sale. Efficiency is likely to be improved and less time is likely to be spent away from actually running the firm, keeping the clients happy and maintain its value and profitability.

- As long as the firm is in good shape, it can show that it has a clear plan and decent financial controls in place, and that any the colleague or colleagues who will be taking it over are already involved in its leadership and management, and IS should reduce due diligence requirements and the need for professional advice will probably be kept to a minimum. An External Succession on the other hand is likely to require significantly more effort, time and therefore cost in this regard.

The key potential disadvantage of an IS from the perspective of the Retiring Principal is that the value they ultimately receive in exchange for selling their interest may well be lower than the amount an external purchaser may be required to pay. This is particularly the case if an external purchaser saw an opportunity to generate higher income from the client base or to reduce the cost base of business operations following transfer. As stated above though, if the value of the lump sum they receive is the seller's only, or principal, consideration it would be very unlikely they would even consider an IS in the first place.

The key potential disadvantage of an IS from both the seller's and the buyer's perspective is that it is highly likely the sale and purchase will have to be funded to some extent by debt. This in turn means that the firm itself and/or or the successors who are purchasing it will have to be both viable borrowers from the debt financier's perspective and whomever takes on the debt will obviously have to be able and willing to service the debt.

This is potentially disadvantageous from the Retiring Principal's perspective because having to part fund by debt will almost certainly place a ceiling on the price they will receive. It might also, depending on the firm's financial position, also delay the point at which they receive full payment, particularly if the firm's ongoing working capital requirements mean that the agreed purchase price has to be paid to them in stages.

On the other hand, IS could create a lot more certainty as to the value the Retiring Principal will receive and when they will receive it. An external sale will inevitably mean that the purchase price will be subject to various caveats and in particular the achievement of certain financial targets such as client retention, switching clients across to the acquirer's proposition and maintaining or increasing fees for a period of time. Because an IS means the successors are simply taking over the firm as it stands, requirements like that have no relevance at all as far as the purchaser is concerned.

Obviously, the successors and the firm will have to service any debt which has been taken on by them. Quite possibly they may also be required to provide security for the lender by giving it a charge over the assets of the firm or by way of personal guarantees, either jointly or individually. However, if they are not prepared to take on debt, the responsibility for servicing it and the offering of any security required, then arguably they may well not be psychologically attuned to becoming business owners anyway. The old adages "nothing in life is free" and "nothing ventured, nothing gained" very definitely apply when it comes to running a firm.

A properly organised and executed IS will provide the colleagues who buy in with full control over the firm in its current form and, hopefully, a very firm foundation and a significant opportunity to build on whatever success it has achieved to date. Obviously, it will also give them as much control as possible over their future professional destiny and, if all goes well and particularly if the firm can grow out from the IS, it should also provide them with long term career satisfaction and a reasonable long term financial reward.

The offer of an IS should be viewed by the proposed successors with gratitude, and with confidence, as both an exciting opportunity and a recognition, and an acceptance, of the trust which the Retiring Principal has placed in them. If it is not, then they are probably the wrong people to take the firm forwards and the outcome is unlikely to be as successful as it could be for all concerned and the Retiring Principal may be best advised to think again.

3. Internal Succession from the Stakeholders Perspective

There are 3 stakeholders in any firm, the Clients who engage with it and who pay fees to it, the Staff who work with in it and who provide the services to Clients and get paid for it, and the Owners of the business.

Generally, the running a successful firm pretty much comes down to achieving and maintaining a balance which treats each Stakeholder's interest fairly and which keeps all of them happy. If the interests of any one Stakeholder are given priority over the others it is highly likely that long term success will be difficult to achieve.

From the perspective of the Owner, the first and most obvious benefit is that IS ensures the continuation of their firm in its own right as an independent entity and, almost certainly, if the successor owners have worked alongside the Retiring Principal for some time and the handover is handled correctly, the firm will continue in the same mould which the Retiring Principal has established.

The feelings of Staff and Clients may well not be of paramount importance to a Retiring Principal who prefers to pursue an External Succession strategy, but the views of both are likely to be a major concern to one who has chosen to follow the path of IS. In this regard a successful should also benefit those other two Stakeholders in the following ways:

- A commitment to IS can make the firm a far more attractive proposition to good quality, younger financial advisers or other key operational staff who are attracted to the idea of sitting at the top table and having greater influence over the running of the firm and a share of the profits assuming all goes well. Setting out a defined route to equity and expectations as to what is required to be offered it should, as long as it is done on reasonable terms, give such key staff a real incentive to develop the relevant skills, competence, experience and attributes which are required to be invited in. Those expectations can obviously also be geared by the Principal, towards closing any gaps in the firm's current structure, competences, or executive responsibilities.

- A promise of equity if certain expectations are met can be viewed as a promise of "jam tomorrow" and, on that basis, employees who find the concept attractive may well be prepared to sacrifice some element of "jam today". The offer of equity participation can therefore assist in reducing staff costs in the short term or it could enable the firm to attract a new colleague at a less than a market rate salary and benefits package. One key point to bear in mind though is that any employee who is worth their salt will have no hesitation in raising the issue if they feel they have been let down or taken advantage of. So if this tactic is adopted, some very clear and measurable objectives must be set in terms of what they need to achieve within what timescale in order for an offer to be made. Equally importantly, such promises must be delivered upon if those objectives are met because if they are not, it is likely a very disgruntled employee will consider moving elsewhere pretty immediately, possibly explaining why they have in the process.

- If one Retiring Principal is replaced by a greater number of successors, then, as long as those successors are of a significantly like mind, the transition could significantly strengthen the firm because the various task involved in leading and managing it can be shared. Almost certainly a range of different attributes, skills, technical knowledge, experience, personalities and competences will also create a much more solid foundation on which to build and make the whole experience of running a firm a lot more enjoyable, a lot more profitable and a lot less risky for those involved. Obviously though if the successors are not sufficiently likeminded the absolute opposite could be true.

- Equally obviously, a promise of equity participation could provide a senior or key employee who is considering moving elsewhere with a clear incentive to stay and progress their career within the firm. This could in turn help solidify the firm and it would inevitably avoid the distractions, costs and disruption that usually accompany having to replace an employee, particularly a key one. It's again worth emphasising though, that a promise which not delivered upon if all other expectations have been met, will be very likely to ensure that the staff member involved decides to leave quite possibly explaining why to other staff in the process.

- Logically, an internal succession should also be quite attractive to all the other members of staff who are not going to be invited into equity participation. They will have worked with the new owners for some period of time, and it is highly likely that if the Retiring Principal has confidence that the successor is the right person to take the firm onwards, and hopefully upwards, then the other staff probably will have too.

- Those staff who aspire to equity participation at some point in the future are very likely to take encouragement from the fact that it has been offered to, and taken up, by some of their colleagues. Obviously, anyone who feels they should have been offered the opportunity to participate in the IS but wasn't, might though think very differently. But assuming the Retiring Principal only offered equity to those who they felt merited it, the risk of upsetting someone who wasn't actually invited in shouldn't cause too many significant difficulties for the firm.

- It is likely that, compared to an External Succession, an IS will result in significantly less disruption to systems, processes and working patterns. Furthermore, if the successors do ultimately want to make any changes, then because they will have a very good understanding of the firm's culture this should equip them to understand how their proposed changes may be perceived by colleagues, to work out a strategy to explain why change is taking place and to ensure that all concerned remain on board. Having worked with the other staff members for some time, it is only logical to assume that the new owners coming in through and IS are far more likely to take their feelings into account than third party owners who have assumed control through an External Succession.

- A key advantage of an IS from the staff perspective is that that there will inevitably be a reasonably long transition period between the Retiring Principal's decision to sell and the new owners assuming control. That obviously presents plenty of opportunity to explain the transition plan properly, to enable all colleagues to understand it, to let them to raise any concerns or points they might like to air and hopefully enable the Retiring Principal and the Successor to address them satisfactorily. A properly managed IS should therefore encourage rather than discourage a sense of security and stability within the existing staff. On the other hand an External Succession is probably more likely to create uncertainty and, potentially, discord. If anything, a successfully managed IS could turn out to be something of a team building exercise and it could reinvigorate a firm and create a stronger foundation than already existed.

The same sorts of benefits are also likely to be achieved for the third group of Stakeholders, which is the Clients.

With the exception that newly retired Principal is obviously no longer involved, they will carry on dealing with exactly the same people that they dealt with under the previous ownership. Unlike an External Succession, an IS almost certainly means there will not be any changes to either the investment

proposition, the administration platform or any other aspect of the service or the fees which they have been used to receiving or paying.
Any Client who was personally advised by the Retiring Principal will sensibly have been matched to and introduced to a new Adviser by them before their departure and, because there will inevitably have to be a transition period, that handover will not need to be rushed.

All the clients who are handed over are likely to take comfort from the fact that their new Adviser has been handpicked by the Retiring Principal and is trusted by them to assume responsibility for ongoing Advice and service. They are likely to be even more encouraged if responsibility for managing their relationship with the firm has been transferred to a Successor who has now taken over ownership of the firm because that, amongst other things, demonstrates that their new Adviser has committed their long term future to the firm, and will also have a good degree of influence over its future direction.

Furthermore, if the Retiring Principal has been succeeded by a number of new owners, or if the IS has assisted in attracting new blood to the firm, most clients are likely to react positively to the increased critical mass which the firm now has. As long as they are of like mind a common purpose, more owners and Advisers should logically create a more solid foundation for the firm operations, because it will reduce the impact of any single key person leaving or suffering a catastrophe.

The Successors should, by this stage be of like mind and common purpose. If there were any interpersonal issues these should all have ironed out during the transition period by following a proper transition plan and process as set out below. Because the Successors future fortunes are now inextricably interlinked, they should positively want to collaborate and share their skills and experience for the benefit of the firm and its clients. Collaborative decision making should, in turn, hopefully lead to good and balanced decisions, the sharing of technical knowledge and experience and collaborative advice should only improve its scope and quality. Because an IS should ensure that the new owners of the firm are highly committed, highly collaborative and properly enthused, this should all logically flow down through the client base and the clients should be equally committed and enthusiastic too.

4. Requirements for a successful Internal Succession

Facilitating a successful IS, requires a number of critical elements to be brought together and achieved. Some of them will interact with others and some of them will be difficult, if not impossible, to achieve without others being achieved and being firmly in place beforehand.

It is important therefore not only understand the critical component parts of an IS, it is necessary to also understand how they interact with each other and in what logical order they need to be achieved.

Some components might be the responsibility of a particular person and others will almost certainly require a collective buy in and collective effort. Planning and setting out a Critical Path which determines priorities and the order in which they need to be achieved is critical. Equally important is allocating responsibility for achieving each task in accordance with the set timescale and ensuring that regular reporting and meetings are set up to track progress, identify issues and ensure that action is taken as required to keep the project on track.

At the top level, a successful outcome will obviously require agreement between the Retiring Principal and the Successor on the price which will be paid and the timescale for completing the both the transaction itself, and the amounts and timing of the payments which will be paid and received.

The business model which has been adopted by the firm, the advice and service it offers and the fee structure which it applies are largely irrelevant in determining the feasibility of an IS.

The crucially important factors are that in order for an IS to succeed, the Retiring Principal must prioritise wanting to sell to colleagues rather than any third party and accept that could reduce the value they receive in exchange, the colleagues who have been identified as the desired successors must have a real desire and willingness to take over the ownership and management of the firm, the ability to plug any gaps which the Retiring Principal will leave as regards its operations, sufficient credibility in the eyes of the other staff to retain their trust and commitment and the willingness and ability to fund payment of the purchase price through a combination of their own and, potentially, the firm's financial resources within the timescale which has been agreed.

Breaking these factors down in further detail, the key attributes to facilitating a successful IS are:

- The Retiring Principal believes very strongly that continued independence will be good for the firm, for its clients and for the team that works within it.

- The Retiring Principal is keen, ideally to the extent they prioritise it over any other consideration, to sell their interest in the firm to colleagues for a sensible and appropriate price, within a sensible and reasonable timeframe.

- That the preferred Successors are willing and able to purchase it at that price and within that timescale.

- That all parties are comfortable with the way the IS will be structured, noting that purchase price and the timescale within which it can be paid may vary depending upon whether the transaction is structured as an Employee Ownership Trust (EOT) or as a Management Buyout (MBO) and that each will produce a different looking form on completion. Both options are described in Section 9.

- That the firm has a positive and very collaborative culture which will welcome and suit an IS, or at the very least that it has the potential to develop the appropriate culture within a relatively short period of time.

- All the parties involved are on board with the concept of an IS and are psychologically on board with the idea of standing down from, or stepping up to, ownership and performing management functions as appropriate. Again, the parties involved will differ depending upon which route to IS is going to be followed.

- A properly thought out transition plan is in place and is followed over whatever time frame is required to implement it. Although it may be possible to implement an EOT fairly immediately, a successful MBO is likely to require gradual implementation over a period of at least 2 and, depending upon the circumstances of the firm, possibly 3 or even more, years.

- The firm is well established and has a good track record of client retention and profitability thereby ensuring it will be a sufficiently attractive business to take over and that it will be feasible to source debt finance to bridge any gap between the cash which can be subscribed by the company or the purchasers, and the cash which will be required to fund the purchase price.

- With that in mind it is also likely to be a significant advantage if the firm either holds, or is able to accumulate during the transition period, some amount of cash which is surplus to working capital requirements.

- The Successor themselves, in the case of an MBO, is willing and able to contribute a reasonable amount of cash immediately in order to purchase an interest in the form at an early stage in the process.

- There is a clear strategy in place to at least maintain and ideally grow the firm's profitability and cashflow, particularly in the case of an MBO, to the extent required to service the proposed borrowing whilst also enabling the Successors to achieve a reasonable return on their investment. This may not be necessary in the case of an EOT but it is very definitely helpful if the Retiring Principal wants to be sure that they do get paid out in full.

- That firm's future strategy is enshrined in a formal Business Plan which includes an integrated Profit & Loss Account, Balance Sheet and Cash Flow, and that Plan is agreed and adopted by all parties.

- The firm is not overly dependent on the exiting Principal, the stronger, more established the team is the better and a good mixture of attributes skills and experience on their part is helpful.

- The new management are equipped to make the transition from being employees to owners, which requires a change in mindset from managerial to entrepreneurial, or all parties need to ensure this is a transition that is achievable within the proposed timescale of the transaction.

If all these boxes can be ticked, the IS route should provide a Retiring Principal with the assurance of both a reasonable lump sum on exit and the best possible chance of ensuring their firm’s continued sustainability with as little disruption as possible, as far as the clients and the staff are concerned.

It is important to note though that these factors do not all have to be in place at outset when the decision to exit via an IS is made. It is actually very unlikely that they will all be in place at outset, and any firm that has already got them all in place right from the off would be in a very fortunate position indeed. The key point is that the IS transition plan must ensure that the factors are all in place by the point of completion.

What is not important is the size of the firm. Although an IS might be more attractive in the context of a larger firm it is very feasible to organise one within a very small firm. A single Retiring Principal and a single Internal Successor will make it perfectly feasible for an IS to succeed.

What is necessary, is that all of the parties involved, particularly the Retiring Principal, recognise and accept that they do need to be in place before the IS can be successfully completed. What it almost certainly then also going to mean is that a successful IS will require planning in advance and that all of the parties involved must buy in to that plan and commit to achieving it.

Depending on what shape the firm is in at outset and what needs to be achieved to facilitate it, it might take up to 3 years, possibly even longer, to bring the plan and all of its constituent factors together. It is probably very unlikely, even in the best placed of firms, that the process could be successfully completed in less than 12 months.

5. When Internal Succession might be less appropriate or feasible

Compared to an External Succession, it is likely that an IS may take longer to achieve, it is also likely to require more input and effort on the part of a Retiring Principal and it may result in them receiving a lower value for their shares than they would receive from an open market buyer. This is particularly true if the open market buyer in question is a Consolidator of financial advice firms who would be able to leverage future profit by switching clients onto its own platform and/or into its own investment proposition.

But to be fair, an External Sale will also undoubtedly take time to complete, will require quite a bit of input from the Retiring Principal and will not in any way guarantee a higher value will be received compared to an IS. It is also very likely that in all cases, the value which the Retiring Principal receives will, in all cases, be directly related to the time and effort they are prepared to put into it. If they want a quick and easy sale and they are not prepared to put any effort into the transaction, they will almost certainly receive a lower value than they could, whether their exit is facilitated by either internal or external succession.

The key point is though that an IS will be probably be less appropriate if the Retiring Principal places a higher priority on either the speed of the transaction, or an easy life, or maximising the value they receive for their shares, than they do to sustaining the firm which they have built, incentivising and rewarding the people who have helped them build it, and creating a stable future for both their staff and their clients.

The corollary of this position is that, for an IS to be appropriate, a Retiring Principal must be sufficiently enthusiastic and determined to exit through in this way. They must be prepared to put in the time and effort required to make it a success, particularly in terms of working with their successors to ensure a proper handover. They must appreciate the handover will take time, possibly a number of years, and they must be prepared to accept that it will. They must also be prepared to accept there could be a ceiling on the value they will ultimately receive and that that ceiling will depend upon what a combination of the business or the Successors can afford to pay to pay. Finally, they must be prepared to accept payment in stages over whatever period the circumstances of the Successors and the business might require.

So, ultimately, if the Retiring Principal needs or wants, for whatever reason, to complete a sale of their shares quickly, IS will almost certainly be neither feasible nor appropriate. This is because it would be unlikely that a firm will have all of the components required to achieve a successful IS in place on day one and, even if it does, a internal transition to the new ownership and control regime should not be rushed.

If corners are cut the Successor may not be sufficiently equipped to take over the management of the firm, the risk of unsettling either clients or staff will be significantly increased, and debt funders may be a lot less confident about lending any capital required to facilitate the transaction.

Probably, the smaller the firm involved and the fewer the number of successors involved the more important it is that the transition happens in a gradual and controlled manner, because the stress and pressures which can result from an insufficiently planned succession will simply fall on fewer shoulders, and fewer shoulders have less chance of absorbing the strain.

The time horizon required to complete a successful IS will vary depending upon the characteristics of the particular firm and the particular personalities involved. The transition is very unlikely to require less than 1 year and it will hopefully take no more than 3. It therefore follows that if the Retiring Principal requires completion within 12 months an IS will almost certainly not going to be the appropriate way to go and, if they require it within 3 years, the firm and the Successors will have to be in pretty good shape to achieve that objective.

It is also important to be aware that, in this context, completion does not necessarily mean that the Retiring Principal will receive full payment by that point. The financial position of the firm may mean that the agreed price has to be paid to them in stages over a longer period of time.

Obviously for an IS to succeed there must be at least one successor who wants to take ownership of the firm, has the skills and attributes required to do that successfully and is also able to contribute some meaningful amount of cash to purchase their initial tranche of shares. If there is no successor who is in this position, then clearly an IS will be inappropriate.

That doesn’t necessarily mean that the successor has to be in place at the time the Retiring Principal decides they want to exit. It may be entirely possible to mould one or more Successors out of colleagues who already work for the firm or, if no suitable candidates are currently employed, it might well be feasible to recruit one or more people who are from outside of the firm. Obviously though, having to mould or recruit a Successor will necessarily increase the timeframe within which the IS will be completed, it will certainly require the Retiring Principal to input more time and effort and they could well also increase the costs involved, because training, down time and possibly recruitment costs will be inevitable. An external Successor may well also be less welcomed by both clients and staff.

In summary, if it is not immediately clear who the Internal Successor is going to be and they are already working for the firm then, although an IS might still be possible, it might well be less likely to be appropriate, it may extend the transition period required and it may, ultimately, render an IS infeasible.

Following on from this point the size of the firm and the number of potential successors can also impact on the appropriateness or feasibility of an IS.

Although it is perfectly possible for a sole practitioner to transfer ownership and control to another sole practitioner, and indeed some Advisers prefer to run a firm on their own, it is also fair to say that operating as a sole practitioner is becoming increasingly difficult and riskier and that trend is almost certainly going to continue.

The Financial Conduct Authority and Professional Indemnity Insurers are alive to the risks of control being concentrated in one person, the costs of running a firm are increasing and a sole practitioner has limited ability to grow and absorb them and a small firm might also be less attractive to clients who are naturally concerned about continuity in the event of holiday, illness or worse.

A small practice might well also find it harder to attract good quality staff and the overhead costs involved in running a smaller firm are likely to be disproportionately high compared to a larger one. The smaller the firm is, the harder it will almost certainly for it to be to negotiate on service and fees with product providers and investment managers and the ability of one person to take on and deal with all the executive responsibilities of running a firm is limited, particularly if they are also responsibility for providing advice and managing client relationships. The process of giving advice is itself getting more complicated and it is becoming increasingly difficult for one person to maintain the competence required to provide all the specialist advice a client may require at different stages of life.

All these factors taken together suggest that the smaller the firm is, the less attractive or indeed feasible an IS may be because it might make it more difficult to attract an internal Successor or make it more difficult to finance an IS. Therefore, the most appropriate and feasible option for a sole practitioner or a relatively small firm might be to exit through an External Succession rather than an IS.

That is, though, a sweeping generalisation though, and if even if a firm is very small if it is generating reasonable profits IS could well be feasible, particularly if the successor is also keen to carry on operating the firm as a sole practitioner and the firm is financially secure enough to make that a feasible option.

The number of proposed Successors and their personal financial positions might be another factor in determining whether an IS will be feasible, because the Retiring Principal, as keen as they may be on an IS, will probably have a bottom line in mind as to the value they require for their interest.

If this is the case there is no point in proceeding down the IS route unless it is clear that a combination of the successor's personal contribution, the financial resources of the firm and the ability of both to raise and service debt finance will enable the shares to be purchased for at least that price.

Even if a proposed sole successor has a sufficient appetite to take on the firm and continue running it as a sole practitioner they will also, almost certainly have limited capacity to contribute cash. The amount they can afford to contribute, whether it be from their own resources or debt, may not be sufficient to bridge the gap between the value the Retiring Principal places on their shares and the amount the firm itself can contribute from its financial resources. So for this reason if there is only one potential internal Successor that might also make an IS more difficult to achieve.

Similarly, because the costs of running a small firm are likely to be disproportionately high, the profitability of a small practice is likely to be proportionately lower than it would be in a larger firm. The key drivers of a firm's ability to raise debt finance in order to complete an IS are (a) its profitability and (b) its ability to generate cash. Any firm will have limited financial resources and will also have a finite borrowing capacity, but smaller firms usually have less of both than larger ones do. The size of a firm and its financial position will therefore, in turn, will also place a natural ceiling on the amount which the Successor should be willing, and will be able, to pay for the Retiring Principal's shares.

From the Retiring Principal's perspective, one key potential benefit of an External Succession is that a third party buyer, particularly a Private Equity backed Consolidator, might well have the ability to substantially improve profits by transferring a firms client base onto its own platform and into its own investment proposition. These opportunities are unlikely to be available to internal Successors, at least not in the short term.

So, the end result, therefore, is that an external purchaser may well be prepared to pay a higher price for the firm than an internal successor. And it is likely that a sensible internal Successor may not, and indeed should not, be able to match the price an external buyer might pay.

Logically a lack of scale and profit may also make the acquisition itself a less attractive proposition from the successor's perspective, unless of course they are a determined sole practitioner or they are acquiring the firm with a view to growing it, merging it to create a larger practice, or potentially even selling it on themselves at some future point.

So, even the Retiring Principal is firmly committed in principle to the idea of an IS, and the internal Successor is in place, and they are very keen to take the firm over, it is very important to check the financial feasibility of an IS at an early stage.

Hopefully the outcome of that exercise will be a meeting of minds on valuation and a clear way to fund the purchase over a period which is acceptable to all parties. But if the outcome is an unbridgeable gap between the financial expectations of the Retiring Principle and what the internal successors are willing and sensibly able to pay, there is probably little point in proceeding any further down that route.

It is though important to note that an unsuccessful outcome at this initial feasibility stage does not necessarily mean that the only option remaining is an outright sale to an external Consolidator.

If the only things holding back the preferred option of IS are the size of the firm, the lack of internal successors or financial constraints, an acceptable halfway house might be to merge with another similarly sized firm which is also resistant to the idea of an external sale, but which also finds itself unable to feasibly complete an IS at the current time.

Combining two or more firms could very well create sufficient critical mass in terms of both personalities and finance and get both of them to the point that an IS of the combined whole becomes feasible. The immediate short-term advantage of coming together like this is it will enable overhead costs to be shared and therefore proportionately reduced. Creating greater critical mass might also provide a better platform for growth in that it will enable best practice to be shared, it should improve negotiating power with product providers and investment managers and a larger combined firm might well prove more attractive to potential new clients and staff.

But, in the meantime, both Principals and their staff will without doubt retain far greater influence over the service which is provided to clients and the fees that are charged than they would through a sale to an external purchaser. Although an interim merger on the way to an IS will necessarily delay that final transaction, the delay may be acceptable to the parties involved if it ultimately achieved that desired end result, particularly if it facilitates a higher value for both Retiring Principals.

It is probably possible, adopting this approach, to build any firm to the point where it has sufficient critical mass in terms of financial strength and personnel to support an IS. What this takes though is a spirit of cooperation and compromise, a recognition that a smaller share of a bigger and probably better whole is preferable to full control of a smaller one, a well thought out Business Plan and sufficient determination to achieve it.

6. The Alternative Routes to Internal Succession

Financial advice businesses will generally be structured from a legal and tax perspective as either a sole trader, a Partnership, a Limited Liability Partnership, or a Company. If they are the latter form, they will invariably be structured as a Company which is Limited by Shares. A Limited Company which constitutes a separate legal entity in its own right, separate from the people who own it, seems to be the predominant preference.

Although it is theoretically possible to implement IS within any of these structures the process it will invariably be easiest if the starting point is a Company Limited by Shares. If the firm is not currently structured in that way it will be important to take specialist legal and tax advice, which is beyond the scope of this Guide, before proceeding down the route of an IS.

What follows assumes that the firm is structured as a Company Limited by Shares and the IS will, therefore, involve the purchase of the Retiring Principal’s shares.

There are, broadly, two ways that the IS transaction can be structured, the first is to create an Employee Ownership Trust, the second is what we will call a Management Buyout.

6.1 Employee Ownership Trust (EOT)

The EOT route is only available if the firm is structured as a Company Limited by Shares. It was created by the Finance Act 2014 to encourage business owners to sell their firms to their employees and as a tax efficient route to enable them to do it. The theory behind the concept was apparently to enable more employees to directly benefit from the performance of the business they work in, in the expectation that should lead to higher productivity which would benefit the economy as a whole.

So, if the Retiring Principal wishes to exit through an EOT the first thing that must happen is the firm must be structured as a company. If it isn't then changing it into one will inevitably involve time and cost and sensibly a need to take professional advice as to the implications involved.

The next crucial point is that and EOT is also only available where a majority of company shares are transferred to an EOT in a single transaction. Therefore, it is not available to a Retiring Principal who owns less than 51% of the company's share capital, unless other shareholders also agree to sell their interest to an EOT at the same time.

The two key advantages of an EOT are:

(a) the seller will qualify for 100% Capital Gains Tax relief, although Stamp Duty must still be paid the sale becomes totally CGT exempt regardless of the size of the business or the price at which it is sold.

(b) once the trust is set up, it can pay annual tax free bonuses of up to £3,600 to employees. But importantly, this option is only available if a majority shareholding in the firm is transferred in a single transaction. It is not therefore available if the seller holds less than a 51% interest in the form.

An EOT obviously involves setting up a trust, which is technically a form of Employee Benefit Trust and must therefore be approved as such by HM Revenue & Customs. It is, therefore, crucial that specialist professional advice is sought in relation to the trust structure and its ongoing operation, it is also sensible to seek clearance of the proposed arrangement, and in particular the valuation at which it will be transacted, from HMRC in advance of completing the sale to ensure that the proposed arrangement qualifies for the favourable tax treatment.

Obviously running any trust involves ongoing complexity and administration. An EOT is no exception and, in particular, it is vitally important that it follows certain ongoing compliance procedures and adheres to the required standards of corporate governance.

If the trust fails to do either the EOT could cease to qualify for the favourable tax treatment and if that happens, the Seller could immediately become liable for Capital Gains Tax.

The trustees' roles are crucially important and quite onerous. Generally, it is sensible to appoint a mix of the people who will in future be running the company and, because it is important the employees actually do have some real influence over the running of the company, some staff members too. Given the onerous rules and regulations which have to be adhered to, an experienced professional is also probably sensible even though that will no doubt add to costs.

The relationship between the trust and the company can be complicated and, in theory at least, their respective interests could conflict. The role of the EOT trustees is to ensure that the company operates in the best interest of the employees, but they are not involved in the day to day management of the business. That role belongs to the Directors of the company. So, in this regard, difficulties could arise if the Directors which to pursue a course of action which the trustees feel is contrary to the best interest of the employees. If that happens and negotiations cannot resolve matters to all the parties satisfaction, significant legal complications and consequential costs could arise.

One potentially very important factor is that, because an EOT offers potential tax advantages, it is a relatively complex arrangement which is subject to various rules and regulations. One consequence of that is that an EOT is likely to find it difficult, if not impossible, to borrow externally in order to fund the purchase of the Retiring Principal's shares. Relatively few, if any, third party debt financiers will be prepared to lend to a trust because:

(a) Under the rules which govern how they must operate, an EOT cannot grant any security or guarantee in relation to any money which it might borrow. It is very unlikely that any lender will lend to any party which cannot offer either.

(b) If unsecured lending is available, it will inevitably only be offered at a very much higher interest rate that a secured loan, in order to compensate the lender for the significantly higher risk involved. That increased interest rate obviously increases the financial strain on the business when it comes to servicing the dent. Potentially it also impacts on the feasibility of the IS and in particular the price which the EOT is able to afford to pay for the Retiring Principal's shares.

(c) An EOT has no assets of its own other than the shares it owns in the company. Therefore, the trust cannot make any money of its own and it is entirely reliant on the company to make profits and to transfer that least some of those profits to it as cash. If no profits are made the EOT would be left high and dry with no funds available to repay any debt. The result is that almost certainly, even if a lender was prepared to lend to the trust itself, it would almost certainly require the underlying company to guarantee any lending.

(d) The Directors of the company have to act in the best interest of the company and guaranteeing the lending of the EOT, which is a separate entity, could therefore compromise them in the exercise of that duty. In particular if a company pledges its assets and future cashflows as security for the EOT's borrowing that will undoubtedly reduce its own borrowing capacity and potentially preclude it from raising any more debt for its own purposes until the EOT's borrowing has been repaid and the security which the company has given has been discharged.

(e) Fundamentally, because the company is now owned and controlled by the trust, and because the employees who benefit from that trust have to play a proper and full role in the management and control of the business, some lenders may take a lot of convincing that the involvement of those employees won't have a detrimental effect on longer term business profitability. Whilst this challenge may also exist to some extent under an MBO, it is probably fair to say that because the successors in that case will have been personally selected by the Retiring Principal, and because they also have "skin in the game", a third party lender will probably be a lot happier to lend in an MBO situation compared to an EOT.

If external funding is not available, or it is not available at an affordable interest rate, the only other options for funding the purchase of the Retiring Principal's shares are to use either any cash reserves which the company has accumulated, or the cash it generates in future from ongoing profits or a combination of both. In either case the cash will need to be transferred from the company to the EOT from where it can be used in payment, or payment for the shares which the EOT acquires.

Obviously, it is crucially important that the company is not starved of cash because if it cannot meet its own working capital requirements neither staff nor bills will get paid and ultimately it could be forced out of business thereby defeating the object of the EOT entirely. This then means that any use of company cash has to be very carefully thought out and, for a start, the company must know what cash it is likely to need to retain. That in turn requires a comprehensive Business Plan, including a detailed cashflow projection and a forecast of the future profits the company expects to achieve and pass up to the EOT. The process of creating such a plan is set out in Section 11.

The Business Plan will, therefore, to a large extent set both a valuation which should satisfy HM Revenue & Customs, the price which the EOT can afford to pay for the Retiring Principal's shares, the time period which it will require to pay that price and the payment instalments which will be involved.

It is very likely that if an IS follows the route of an EOT it is usual that the Retiring Principal will necessarily have to receive payment for their shares over a period of years. As will be seen in the following Section, this is also very likely to be the case with an MBO, but in that scenario there is considerably greater likelihood that external debt funding will be available. If it is the time period required to pay out the Retiring Principal could be reduced considerably.

If the Retiring Principal wants to be paid out as quickly as possible they may well prefer to exit through an MBO. If they are mainly motivated by CGT exemption and they are prepared to accept both the risk that it could be lost if the trust doesn't stick to the rules and that they may have to wait longer to receive payment in full, then the EOT may be the way they choose to go.

One major difference between an EOT and a Management Buyout is that the former is a relatively blunt and inflexible approach.

Any annual bonuses which the trust wants to pay must be paid to every eligible employee and every eligible employee must receive an equal amount.

Although the concept of enabling all employees to share in the firm’s profits might, on the face of it, appear to incentivise the entire staff, it could also be perceived by some colleagues as rewarding people who might not actually deserve it. If this becomes the case it could well negate any incentivising effect which the EOT was designed to instil. Even worse, it could actually have exactly the opposite effect and disincentivise the colleagues who think they deserve a reward more than others. An EOT route is very definitely not without risk from this perspective.

To be fair, it is possible to restrict which employees are eligible to receive a bonus payment by defining eligibility in terms of position, length or service or salary for example, or by building in restrictions which are designed to ensure that only employees who have proved their worth and their commitment can participate. But this will inevitably increase the complexity involved in operating the EOT, they have to be very carefully thought through or they could compromise the tax treatment and, again, they could cause divisions amongst the staff.

Philosophically though, what an EOT does do is potentially enable all employees to share in company profits, so it can act as an incentive in the right firm where the senior team, and particularly the Retiring Principal believe that given the firm’s culture and colleague base, it will have an incentivising effect.

But it is questionable whether eligibility to participate in an EOT does represent a significant incentive. Although every little helps, and an additional tax free bonus of up to £3,600 per annum could be very valuable for lower paid and more junior staff, it is obviously of more limited benefit to more senior and higher paid staff. Clearly also, whether or not any bonus is actually paid will depend firstly company profitability and how much the directors distribute to the EOT, and secondly on the discretion of the EOT trustees as to how much bonus is actually paid.

No employee will actually be made worse off if no profit share is forthcoming, because participation in the EOT is free as far as the eligible participants are concerned and none of them have had to contribute financially. Arguably therefore because an EOT does not really require them to put any "skin in the game" the incentive of a relatively small tax free bonus, which may or may not be paid, might not be as strong as the Retiring Principal expects.

The corollary of that argument is that because entry into the EOT is free it potentially enables lower paid or more junior employees to participate and, hopefully, develop some sense of "ownership" and participation which may increase their sense of loyalty and desire to progress their career within the firm.

Crucially, it is the company directors who are responsible for allocating company profits, and it is they who decide whether the company's cashflow requirements mean a distribution to the EOT is affordable.

In making that decision they will have to consider contract between the Retiring Principal and the EOT which governs the order of priority when it comes to applying the company's cash. It is likely, because the Retiring Principal will sensibly have insisted, that the contract will dictate company profits and cash must be applied to repay the debt owed to the Retiring Principal, it might also require that the debt has to be repaid in full before any bonuses can be paid.

So in the case of an EOT it could be unlikely that any bonuses will be paid to staff until that liability has been discharged in full and that could take several years to achieve. On this basis, even if the EOT is initially perceived by staff as a very good thing, it could, within a couple of years become viewed as a bit of a "red herring", and any initial enthusiasm on the part of staff could begin to wane.

Obviously, the Retiring Principal could take a view on this and build in some potential to pay bonuses right from the start but that will, inevitably, extend the time it takes for them to be paid out in full. Whether or not they are prepared to do that is a question only the Retiring Principal can answer.

From the perspective of the company and its management an EOT can also create something of a straitjacket which can have a detrimental impact on future decision making.

The EOT structure will inevitably give the employees more of a say in the future of the business and certain key decisions may become subject to their approval going forwards. The trustees will also inevitably own a majority share in the firm on behalf of the participating employees, and they have a right to interject if they consider that the firm's directors and management are not acting in the best interest of the employees they represent.

It may well be that the Retiring Principal would sensibly also impose some restrictions in the sale contract so that the directors cannot make certain decisions without their consent until such time as they have been paid out in full. If they are too onerous, they could compromise the spirit of the EOT and potentially its tax efficacy. It will probably be a lot easier to impose such restrictions in an MBO situation because that is an arm's length transaction between the Retiring Principal and Internal Successor and no fiduciary responsibilities or complicated regulations need to be observed.

The rights of trustees and employees to participate in decision making will be enshrined and can be, to some extent, curtailed, by the EOT Deed. But if that is drafted too restrictively either it could fall invalidate EOT qualification or it could also lead to a feeling of disillusionment spreading amongst the employees it was supposed to enthuse.

One final potential complication is that any Capital Gains Tax exemption which was claimed on the sale of shares to the EOT will be lost if the EOT does not continue to meet the qualifying criteria.

If the EOT fails to do that between the point of transfer and the end of the following tax year any CGT liability will fall on the Retiring Principal who sold the shares. If it happens at some point after that any liability will fall upon the trustees. Furthermore, if the EOT ever re-sells its shares to the extent it no longer owns a controlling interest, the trust will become liable for Capital Gains Tax at that point. Its base cost will be the value of the shares on the date the original seller acquired them rather their value at the date the EOT acquired them. This can significantly increase the tax liability and the EOT cannot reclaim any part of it from the original seller.

Taken as a whole these provisions can reduce the scope to bring any other party into equity without significant tax liabilities arising. That obviously could restrict the firm's ability to attract new employees or additional investment.

So, while an EOT may be an option it is certainly quite a complex one, and specialist legal, accounting and tax advice must be obtained and considered at the Initial Feasibility Stage so that the full implications can be properly assessed and understood before any decision to implement one is actually reached. It is probably also sensible to obtain HM Revenue & Customs Clearance of the transaction in advance so that all parties can be sure the proposed transaction will qualify for the EOT tax treatment that they are expecting.

6.2 Management Buyout (MBO)

In this scenario the Retiring Principal sells their shares, and transfers ownership of the firm, to a colleague or group of colleagues whom they have specifically selected to be their successors, who then take over the leadership and management roles. This is a direct person to person transaction and no form of trust is involved and because of that, once the transaction is completed the ongoing running of the firm will potentially be a lot simpler.

Following an MBO the firm's management will have complete control and, unless the sale contract insists that the Retiring Principal has influence during the pay out phase, their decision making will not be complicated or fettered by the need to involve anyone else.

It is obviously arguable that having to discuss certain matters with the trustees of an EOT might result in better management decisions being made but assuming the Successor in an MBO has been carefully chosen and prepared, hopefully their decision making will be sound so from this perspective an MBO will be preferable.

It is important to point out though that although an MBO might in principle be a simpler way to transfer control and ownership than an EOT, this does not mean that transition itself will be any easier. For the reasons outlined below it the transition through an MBO could actually be more complicated and it might also take quite a bit longer to achieve a successful transition through this route, than it might an EOT.

An MBO will be tax efficient than an EOT from the Retiring Principal's perspective. This is because the sale of their shares will not benefit from immediate Capital Gains Tax exemption like it would through an EOT. Unless they can engineer CGT relief through another route such as EIS investment, they will almost certainly incur an immediate, and potentially significant, CGT liability. Having said that, the sale should qualify for Business Asset Disposal Relief and, as long as this is the seller's first or only such disposal, a favourable CGT rate of 10% on the first £1 million of gain realised.

It is important to also note that any tax liability which does arise may well also need to be paid in full before the Retiring Principal has received full payment for the shares they have sold. It might well be important to take this point into account when planning how the transaction will be financed and how and when the Retiring Principal will actually be paid.

On the other hand, one key possible advantage of an MBO to a Retiring Principal is that, because the succeeding colleagues would be expected to put up some cash at an early stage as set out in Section 9, and because it should also usually be possible to at least part finance an MBO with external debt, this route may well enable them to receive full payment for their shares more quickly than might be the case through an EOT.

If the firm itself has sufficient cash resources to purchase the Retiring Principal's shares at the price which has been agreed, it could be that in theory no external debt is required. But from the Retiring Principle's perspective because they own the firm, they also effectively own the cash it holds in the bank until such time as they sell it. So, if the firm's cash is used to purchase the shares, the Retiring Principal will effectively use their own cash to buy their own shares, and this then means they would be making a free gift of the business to their successors. That is unlikely to be acceptable to even the most benevolent of Retiring Principals. Most will usually want to extract any cash which is surplus to working requirements by paying themselves a special dividend before the transaction completes.

Inevitably therefore, an MBO is almost certainly going to be funded by a combination of the cash which the successor colleagues inject, by external debt and, assuming that the Retiring Principal is prepared to defer some of the payment until a later date, by ongoing company profits and cashflow.

Taking on debt is not entirely straightforward for any business but particularly it isn't for a regulated financial advice firm. Obviously, any business which takes on a debt will incur a legal obligation to repay it with interest, but regulated financial advice firms must also meet whatever minimum standards the Financial Conduct Authority requires in terms of Capital Adequacy. Any debt will have to be reported on the firm's regular Reg Data Return and the Regulator will need to be satisfied that the firm is able to meet its obligations to repay any debt, particularly if it suffers a bit of a downturn in trading conditions.

The issue is further complicated because, without going too far into accounting technicalities, the Reg Data return requires the firm to recognise the debt which it owes but it will not permit it to recognise the equal and opposite value of the asset which the debt has been applied to purchase (ie the "Goodwill" value of the Retiring Principle's shares).

The result is that if the firm itself takes on any significant amount of debt to fund an MBO this will almost inevitably cause it to fail the Capital Adequacy requirements. That is the case even if it can show it will have no difficulty at all in servicing the debt and repaying it in full in accordance with the lender's terms.

Another complication is that any debt which is required will have to be provided to the party who is acquiring the Returning Principal's interest and it is unlikely the lender will lend the money to anybody else. Obviously if those shares are purchased directly by the Successor, they will have to take on the debt personally and that is probably something they would like to avoid.

So, although each firm and each MBO transaction is different and professional advice must always be sought in that context, if it is going to be part financed by debt, an MBO transaction will very probably need to include the incorporation of a Holding Company as a vehicle to purchase the Retiring Principal's shares so the transaction can proceed on the following lines:

- The Holding Company is established by the Internal Successor who is ultimately going to assume control and ownership of the business. If there is more than one Internal Successor, they allocate the shareholdings in the Holding Company between them in whatever way they deem appropriate, taking into account any agreement they have reached between them.

- This Holding Company is an unregulated entity it will have no regulatory restriction when it comes to incurring debt.

- Capital can then be loaned to the Holding Company. It can be loaned by an external financier or, if the financial advice firm has surplus cash available, that too could be lent so as to reduce the amount of external finance required.

- The Holding Company then uses the debt capital it has acquired to purchase the Retiring Principal's interest in the regulated advice firm.

- It will then simplify matters on an ongoing basis if the shares which the successors acquired in the regulated firm are concurrently exchanged for further shares in the Holding Company.

- The result is that the regulated firm is now 100% owned by the Holding Company, which is itself owned by the successors in whatever proportion they have agreed.

- The debt is sitting in the unregulated Holding Company and is quite legitimately separated from the regulated financial advice firm's balance sheet and ongoing Reg Data Returns.

- The regulated financial advice firm carries on operating as it always has. The profits it earns are passed up to the Holding Company in the form of tax efficient dividends.

- The Holding Company then has cash available which it can apply to service and repay its debt.

Sourcing debt finance should not prove difficult as long as the regulated financial advice business has a well established, reasonably profitable trading history and it can demonstrate that the change of ownership and control will not compromise, and will ideally enhance, its future trade and profitability. Essentially what will be required is a properly thought out, properly stress tested Business Plan, as set out in Section 11, which shows that the debt which is being requested is a sensible amount and that the business will be able to service and repay it within an acceptable period of time.

Different lenders will though offer different terms in terms of the amount they are prepared to lend, the time period over which they are prepared to lend it, the interest rate which they will charge and the terms of any security which they will require to cover them against nonpayment. These terms will be dictated principally by the circumstances of the specific firm in question and the quality and competencies of the Internal Successor who will be taking the firm forwards.

It is probably always worth asking the firms existing bankers to quote and it is always sensible to obtain several quotes from various different potential lenders. If the parties involved are not experienced in raising debt capital it is may be in their best interest to arrange funding through a specialist broker who understands both financial advice businesses and the lending market.

6.3 Tax Considerations & Consequences

The tax implications of IS are potentially complex for both the Retiring Principal and the Internal Successor and they will depend very much on the particular circumstances of the firm, the people and the structure involved. The author is not a tax expert, a detailed explanation of the possible implications is not possible within this text and it is imperative that professional tax advice is obtained in all cases before proceeding.

The Retiring Principal would be very wise to seek such advice at a very early stage because, although the differences in tax treatment between an IS and an external sale are unlikely to be significant, the two different routes to an IS, MBO or EOT, will each result in a fundamentally different tax treatment as far as they are concerned.

It is highly likely that whichever is followed, all professional advisers will recommend that HM Revenue & Customs ("HMRC") clearance is sought in advance to obtain assurance that the tax treatment which is envisaged will not be challenged post completion. This can only happen when the full details of the proposed transaction are known, and clearance should not be sought too far in advance of the proposed completion date. Given the complex nature of an IS transaction, if clearance is not sought there could always be risk that HMRC may suggest a different tax treatment is appropriate and the increase in tax liability could be quite substantial.

6.3.1 EOT

The tax advantage of an EOT as far as the Retiring Principal is concerned is that the sale of their shares will not be liable to capital gains tax and, despite the fact the EOT will be structured as a discretionary trust, the transfer of shares to

the trust into it will not constitute a chargeable lifetime transfer for inheritance tax purposes, so no lifetime tax liability from that perspective either.
The trust itself is also exempt from inheritance tax periodic and exit charges.

From the employees' perspective, for those that qualify for inclusion amongst the class of beneficiaries the trust will be able to distribute an annual bonus of up to £3,600 to each of them without them incurring a personal income tax liability. This tax advantage will obviously only be received if bonuses are actually paid.

And from the company's perspective it will be able to claim corporation tax relief on the value of any bonuses paid.

It is worth noting that, at the time of writing, HMRC has launched a Consultation on the tax treatment of EOTs.

One historic issue has been that any distribution of profits to the trustees is potentially liable to income tax in the hands of the shareholder who receives it. Historically HMRC has generally been happy not to tax distributions which are paid to EOT trustees solely for the purpose of repaying the Retiring Principal the amount which is due to them for payment of their shares, but obtaining clearance on this point requires time and potentially money and it is not, therefore, technically very satisfactory. One encouraging point is that it appears that HMRC is going to request tax exemption for such payments to be written into the legislation so that clearance will not need to be obtained in future every time a payment of this nature is paid to the Retiring Principle.

However, the main thrust of the Consultation appears to be that HMRC really wants to ensure that EOTs remain focused on the objective of legitimately rewarding employees and ensuring that they have a proper say in the running of the firm involved.

It is also pretty obvious that HMRC has concerns that an EOT could be used as a way for a Retiring Principal to derive some potentially valuable tax advantages without actually ceding very much, if any control or encouraging much employee engagement.

It seems logical to infer from the Consultation document that HMRC has concerns that the current framework is open to abuse in this regard and that it is also is very keen to crack down on the potential for that outcome to arise.

Specific proposals set out in the Consultation Document include:

- Ensuring that a Retiring Principal cannot act as sole trustee of the EOT

- A requirement that more than half of the trustees cannot be either former owner nor persons connected to them and

- A further requirement that employees should be adequately represented on the company's board of directors.

Taken as a whole it seems pretty clear that HMRC is intent on ensuring the EOT route, and its potential tax advantage, is only open to Retiring Principals who are legitimately happy to relinquish control.

Obviously, that will be the case where a Retiring Principal really does want to retire, but if they are thinking of retaining any influence in the running of the firm after they have retired it may be that the Consultation could affect the way they are planning to do that.

If the EOT ceases to meet the qualifying conditions, which may obviously be varied from time to time, the tax relief will be revoked. If that happens within 12 months of the sale of shares to the EOT the resulting tax liability will fall back on to the Retiring Principal. If it happens at a later date it will fall on the trustees.

6.3.2 MBO

As long as the Retiring Principal owns at least 5% of the firm and they have owned their interest for at least two years prior to the IS completion date, the sale should qualify for Business Asset Disposal Relief.

This relief means that the capital gains tax rate applied to any gains arising on the sale of a qualifying business asset, which includes an interest in a trading business, liable to tax at a rate of just 10%, as opposed to the usual rate of tax on a non real property transaction which is 20%, or 28% for higher rate taxpayers.

It is though vitally important to remember that where shares are being sold, in order to claim this relief, the Retiring Principal must be an Office Holder or Employee of the firm at the time the shares are sold. If they retire in advance of the sale and cease to be so the sale of their shares will no longer qualify and the valuable tax relief will be lost.

Another potentially very important point to bear in mind is if a Retiring Principal sells their shares back to the trading company, rather than to a holding company, their sale will only attract this favourable capital gains tax treatment if the purchase by the company was for the benefit of the company's trade.

If the Retiring Principal really does retire and they have no further involvement in the firm this should not cause any problems. But if they sell their shares back to the trading company directly and then remain involved in the running or management of it that could risk the favourable tax treatment. Where the shares are purchased by the trading company a limited amount of continued involvement for a very short time may be acceptable to HMRC, but long term ongoing involvement, especially where a contract of employment or self employment is involved, is very likely to fail this test.

If the test is failed the transaction won't qualify for capital gains tax treatment the price the Retiring Principal received for the shares would be treated as a dividend rather than a gain. That would result in them incurring an income tax liability most if not all of it would be taxed at a rate of 39.35%.

This issue should not arise if the Retiring Principal sells their shares to a holding company as will invariably be the case if the IS is part funded by debt. But if no debt and no holding company is involved, it is definitely safest from a tax perspective if the Retiring Principal has no further involvement with the company at all post completion.

The capital gain will crystallise in full, on the sale price which has been agreed, whether or not the Retiring Principal receives payment of that price in full on completion. Whatever liability does arise will have to be paid in full within 9 months of the end of the tax year within which the IS completes and It may well be that the terms of the IS result in the Retiring Principal receives payment in stages. If this is the case, they must obviously ensure that, taking into account whatever other resources they may have available, the lump sum they do receive on completion is at least sufficient to meet the full amount of the tax liability which will arise.

It is also important to remember that as soon as the Retiring Principal sells their interest the capital which it represents will cease to qualify for inheritance tax business relief.

Assuming the value of their estate exceeds any inheritance tax relief available to their executors, the value of any cash received by them or any debt which is owed in respect of deferred consideration will become immediately liable to inheritance tax. This may not be an immediate concern, particularly if they are married, in good health and they have made an appropriately drafted Will, but it is definitely worth bearing in mind particularly if they are in ill health.

If an immediate inheritance tax is a concern, then a possible route to be avoiding that could be to invest the whole of the proceeds received into other business assets and to structure any deferred consideration so that it is received in the form of preference shares rather than cash. This will obviously increase the complexity of the transaction and proceeding with HMRC clearance in advance would be even more risky than usual. If the Retiring Principal is in particularly ill health to the extent death is foreseeable it could well be most appropriate from a tax perspective not to conclude the IS transaction.

One other crucial tax implication which must be considered in relation to an MBO is that, if the Internal Successor acquires their interest in the firm for a price which is less than its market value, they will almost certainly incur an income tax liability.

This will apply whether the shares are purchased at the stage they initially buy in or the date at which the IS transaction completes. Any discount between the market value of the shares and the price at which they are purchased will almost certainly be deemed to constitute a taxable benefit which has been received by virtue of their employment. The taxable value of that benefit will be the full amount of any discount they received. Any liability which does arise will have to be settled within 9 months of the end of the tax year in which it arises.

So, although the Retiring Principal can sell their shares at below market value if they wish to, and the successors will almost certainly benefit if they do, it is vitally important to ensure that this does happen the successors are informed of the potential tax liability they have cash available to pay it.

6.4 EOT or MBO?

Obviously an EOT is only available if the form is structured as a company and a majority interest is sold to the trust.

Assuming those hurdles are cleared, whether an IS proceeds as an EOT or an MBO is a decision which lies fairly and squarely with the Retiring Principal. They could make it in consultation with colleagues, but they really don't have to, and they are in complete control.

It is probably fair to say therefore that the most appropriate option for them, or at least the one they select, will depend upon the Retiring Principal's priorities, their views on the firm's culture and its workforce, and the relationship which exists between the workforce and the firm's leadership and management.

Given that an EOT will exempt their share sale from capital gains tax whereas they will pay tax, probably at 10% by selling through an MBO, their views on this tax bill will also be a factor.

And the other crucial consideration may ne how quickly they would like to be paid out. It will be very much more difficult, and potentially impossible, to fund an EOT by debt finance, so the speed with which the Retiring Principal gets paid out is likely to depend wholly upon company cash reserves and future profits. It should be relatively easy to at least part finance an MBO with external debt. If the company has substantial cash reserves and profits there may be no difference in time period but, if it doesn't, debt finance could mean an MBO will be able to facilitate full payment far more quickly than an EOT possibly could.

Given the whole aim of IS is to preserve the firm's independence and sustain it into the future, what should also be important is the Retiring Principal's view as to which option is likely to achieve the best result from this perspective.

In this regard the philosophy underlying EOT legislation is that if all employees feel they have "skin in the game" that is likely to improve productivity and build a more successful and profitable firm which will then be likely to direct more cash back to the Exchequer in the form of taxation.

Whether or not an EOT will generate that culture is certainly debateable. Almost certainly it won't if the employees don't receive any direct benefit in the form of tax free bonuses. For that reason, and also because reading between the lines of the current HMRC Consultation confirms this, an EOT should very definitely only be implemented if there is a legitimate intention to share future profits and give the employees some significant influence in the running and management of the firm.

One key consideration is whether an EOT result in the employees actually perceiving that they have "skin in the game". The EOT option means they are effectively being promised, but not guaranteed, a share in profits and a voice, but they have not been asked to contribute anything in exchange. The more interested and aware will also very quickly work out that the promise is not cast in stone or concrete, and any financial benefit is totally dependent upon whether the company directors choose to exercise discretion in their favour. That discretion exists no matter how much time and effort the employees put in and how productive and profitable the company is.

Another factor might be the extent to which a tax free bonus of up to £3,600 is perceived as a material benefit. The higher the average wage paid then probably the less importance will be attached to it. If the majority of the firm's staff are paid relatively low salaries, then a bonus of this size could obviously be perceived as very substantial. If the average salary is reasonably high it may well not be viewed as material and thus lose its impact.

Following on from this, it is important to remember the EOT has to include all eligible employees and, there is limited scope for bonuses to be given to some employees but not to others. An employee who has the wrong mind set could be tempted to just sit back and let others do the work safe in the knowledge they will receive an equal share of any bonus which is paid. There is, therefore, an obvious danger that an EOT could generate division rather than cohesion if some employees are perceived by others to not be pulling their weight.

Another factor worth considering is whether the firm actually has a workforce that wants to have a voice and some influence. Not everybody wants to be involved in running their firm and many employees simply want to go to work, earn a wage, do what they are told to do and forget all about their job when they are not at work. If the majority of the workforce is that type of person an EOT may well also have less impact on it than was intended.

An EOT certainly carries considerable risk that, if the employees perceive they have been promised a share and a voice and they don't actually receive one, then the perceived incentive could very quickly turn full circle and become a real disincentive. In a worst case scenario, it could lead to the firm disintegrating.

Bearing in mind an EOT is likely to mean the Retiring Principal is paid out over a longer period than an MBO, there could be a real risk in this scenario that they may not actually get paid out in full.

An EOT could also wrap something of a straitjacket around the firm's management and their future plans. The majority shareholder in the firm will be a trust and the trustees of that trust are legally required to represent employees' best interest. On the other hand, the firm is still run by directors who have a legal obligation act in the best interest of the business.

Hopefully the two respective interests will coincide but there will almost certainly be times when they don't, and the EOT structure could, therefore, cause difficulty. This risk could be about to increase because it seems pretty clear from HMRC's current Consultation that EOT's are likely to come under increased scrutiny to ensure that employees interests are legitimately being represented, listened to, and considered. This structure could, therefore, impact on both the flexibility management has to make decisions and the speed with which they can implement those they make.

An MBO on the other hand, will, as set out in Section 9, mean at least one other chosen Successor has put proper financial "skin in the game" at a very early point in the process, and their interests are pretty much directly aligned with the Retiring Principal's from that point onwards. An MBO is a way to directly incentivise one or more key colleagues whom the Retiring Principal has specifically identified as having the attributes, including the necessary determination and enthusiasm, to take over the leadership and management of the firm.

The Internal Successor in this situation will have earned, and will have effectively purchased at an early stage, the right to express a view and to have input during the transition period. But the Retiring Principal will only have selected them if they feel those views are worth hearing and input that is worth having. The Retiring Principal should be delighted that at least one other person is involved in the decision making process and in sharing the management and leadership role. The right Internal Successor will probably enable a Retiring Principal to begin devolving responsibility for both management and client responsibilities far earlier than an EOT will allow.

Once an MBO has completed the Internal Successor will the freedom to run the firm as they feel it should be run, without having to discuss matters or consult with anyone else if they don't want to. Obviously, whether this ultimately turns out to be an advantage or a disadvantage will depend on the Internal Successor involved.

Crucially, they will also have complete discretion to incentivise and reward any particular colleague or colleagues who they think deserve it, to whatever extent they think is warranted. If they don't feel any reward is deserved, they will not have to make one. Admittedly the colleagues will have to pay tax on any reward they receive but ultimately the rewards will be far more targeted and invariably warranted. Because they are so, it is also likely that those who receive them may well receive a greater financial reward than they would have through an EOT even after taking into account any tax they have paid.

So ultimately an MBO could, compared to an EOT, provide a quicker smother route to retirement and probably enable a Retiring Principal to both phase out and be fully paid out more quickly than an EOT. It will also mean that the firm is much simpler to run in the future because fewer people and less bureaucracy are involved in doing that, whilst also enabling other key, or particularly hard working staff to be financially incentivised, without having to also reward other less deserving staff in the process.

The result could well be an MBO ultimately creates more cohesive and successful firm. The only obvious downside from the Retiring Principal's perspective is they will have paid some capital gains tax on the sale of their interest.

7. The Need to Plan

Any sale of an interest in a business is obviously a transaction involving one or more sellers who want to sell their interest and one or more buyers who want to buy it.

An IS though, is different to an external succession in that the parties involved will probably have worked alongside each other for some time, they will know each other well, they hopefully all feel a good degree of loyalty to each other, and they are quite possibly, to some extent friends.

This then means that interpersonal factors might introduce an added dimension and a degree of "political complexity" into an IS which probably wouldn't exist if the firm was sold to a previously unknown third party in a more dispassionate, wholly commercially focused, solely business oriented external sale.

Wherever there is a transaction between a seller and a buyer it's obvious that competing interests are involved, and therefore potential conflicts of interest, arise.

In the case of an IS these conflicts will manifest in the following ways:

- The Retiring Principal obviously wants to exit at what they perceive is fair value but by virtue of the fact they are considering an IS they will also want to sustain their firm and probably also incentivise their colleagues to buy it and give them an opportunity to achieve long term rewards.

- The Internal Successors who are buying in through an MBO obviously want to ensure in the former case that the firm is operating on firm foundations and is in good shape, so it is worth buying and it is likely to achieve future growth. If the IS proceeds as an EOT they will want to ensure that the resulting form will be sufficiently strong and financially viable to both enable them to fulfil their obligations as trustees and finance the Retiring Principal's payout without threatening its future survival and the jobs of the employees involved.

A potential conflict arises because (a) the seller will need the purchasers to work with them to build and sustain the firm and its profits, so that at the end of the day the firm has a value, is worth buying and will facilitate an IS. But in doing that (b) the Successors in an MBO will logically be working hard to increase the value of the firm and, consequently, the price that the seller wants them to pay for it through MBO. This conflict is possibly avoided to some extent by an EOT situation, but even in that one the employees who work to increase profits take a significant risk that ultimately it will be the Retiring Principal who benefits from the value created rather than them.

It is clearly in the Successor’s financial interest not to put in too much time and effort so that the profits are lower, and its value is correspondingly less. Arguably, as long as they don’t destroy the firm to the point it is no longer feasible to buy it, it could be in their financial interest to work against the Retiring Principal in an attempt to reduce the price they have to pay to acquire it or the pressure they will put themselves under in future to ensure the Retiring Principal is paid out.

Furthermore, from the Retiring Principal’s perspective, as they work with the buyers to bring them into the business during the transition period to ensure the firm is in good shape and that the purchasers are as well-equipped as possible to take it on, they could feel they are putting in time knowledge and effort which will ultimately benefit those buyers rather than them.

So, if it is going to succeed, an IS transaction will, therefore, even more so than in the case of an external sale, need to fully and properly consider the interests of all parties and ensure that the proposed transaction achieves a balance between them, in terms of time effort and value, which is acceptable by both “sides”.

All of the parties involved need to be aware that achieving that balance may take time. Ideally, they will be able to achieve it themselves but employing an experienced external Consultant could well help to facilitate discussions, mediate between any competing views and negotiate a plan which is perceived as fair and therefore acceptable by all concerned.

Even if all of the foundations required to complete a successful IS exist straightaway, approaching the IS, a 3 stage process in stages is likely to achieve a better balance between the competing interests regardless of whether it is achieved through either an EOT or an MBO.

Because a staged approach should also ensure that all parties feel that their interests are being treated fairly this should, in turn, significantly increase the likelihood of a successful outcome, whilst also reducing the risks of a fallout between them before the process has been completed.

The stages involved are:

1. Initial Feasibility Study and deciding whether an IS will be feasible

2. Deciding upon the preferred form of IS

3. Preparing an Initial Business Plan to establish the value of the Retiring Principal's interest and a basis for discussion with the proposed Internal Successor

4. Agreeing the Sale with the Internal Successor

5. Refining the Business Plan to ensure it is attractive to other Stakeholders and, if appropriate, potential funders

6. Implementation of the Plan & the transition into new ownership

7. Completion

It should be apparent therefore that a successful IS does not happen overnight. A series of steps are involved, each should be completed in the correct order before moving on to the next. Depending upon the firm's current situation, the personalities involved, the form of IS which is to be implemented and how it is going to be financed, the process would be very difficult to complete within 12 months and, as has already been said, is more likely to take up to around 3 years to complete.

8. Initial Feasibility Study

The Retiring Principal might be very certain in principle that they wish to exit their firm through an IS, but it is sensible to conduct a proper Initial Feasibility Study ("IFS") to check that this route will be feasible in terms of the value they expect to receive and the timeframe over which they expect to receive it, before they broach the subject with any potential Successor and before too much time, effort and money is expended.

Making the firm's staff and/or the potential successors aware of the intention to complete an IS could cause difficulties if, for whatever reason, it ultimately proves impossible to see the transaction through. If that happens for a start a lot of time, effort and potentially money will have been wasted but, perhaps more importantly people's hopes may have been raised and then dashed. That, ultimately, could have very unfortunate implications for the firm, its clients and all of the colleagues involved. The idea behind an IFS is that the IS will only become public knowledge once the Retiring Principal is as sure as they can be that it will be able to proceed.

The most likely reason that an IS will fall through is that it can't be completed on terms which are unacceptable to the Retiring Principal. This IFS should therefore check what kind of value the Retiring Principal is likely to receive through an IS, over what sort of time period, and it gives them the opportunity to make a better informed decision as to whether they wish to go any further down that route.

In the unlikely event the Retiring Principal has no idea of what value they would like to receive, or the timeframe over which they would like to receive it over, the other key benefit of an IFS is that it will give them a pretty clear picture on both points. Once they have that it will probably solidify their thinking one way or another - either the IS will be feasible, in which case the idea can be put to the potential successor to see what they think, or it won't be, in which case no-one else need ever know it was a possibility, and no disruption will have been caused.

The IFS basically involves reviewing whether and to what extent the key factors required to facilitate a successful IS are in place. Almost certainly some will not be, and the aim then is to work out which are not and what work will be required, by whom to ensure they will be in place and what timeframe and cost will be involved to achieve that.
The IFS will also involve calculating the value of the Retiring Principal's interest, at least to the point there is a sensible starting point for any discussions about price, and it will also work out, broadly, over what timeframe it will be reasonable to expect and require payment to be made.

The end result should be the Retiring Principal has a very clear picture in their mind as to the transaction which they will put to the proposed successor. They should also have a clear plan as to who the proposed successor is going to be, what price will be required to be paid over what timeframe and, assuming those terms are acceptable to the successor, an outline plan of action to bring all of the factors together in order for the IS to succeed.

Alternatively, if they have decided that an IS will not actually be feasible, they will simply put the idea to bed and focus their efforts on identifying an external purchaser. The information gathered during the IFS and the thinking process involved will not have been wasted. They will probably now be in a better position to initiate discussions with an external purchaser than they would otherwise have been.

8.1 The Principle

An IS will require various people to expend considerable time and effort, it will involve costs and very importantly it will result in the expectations of certain, probably key, employees being raised. If the IS isn't brought to a successful conclusion a lot of resource could be wasted and some people could be left rather disillusioned, potentially to the extent if it doesn't they might seek opportunities elsewhere.

So, the starting point for a successful IS without doubt is that the Retiring Principal must be totally committed to achieving it. In order for them to be so, they really do need to understand and be sure on a number of key points, including that:

- They really are psychologically attuned to an IS transaction – it has different implications from this perspective to an External Succession.

- They are happy with the value they are likely to receive for their interest – noting it may have to be lower than they might realise through an External Succession.

- They are happy with when they are likely to receive payment. Like an External Succession they will almost certainly be paid by instalment but payment in full through IS could require more instalments and more time.

- They understand what shape the firm is in compared to where it needs to be to complete a successful IS, including where any gaps might exist, what action will be required to close them and what the time, resource and cost implications might be.

The aim of the IFS is to answer these crucial questions in a relatively short space of time and at relatively limited cost, so that the Retiring Principal can make a much better informed decision as to there they do wish to pursue an IS before the plan is discussed with anyone else.

If a decision is made to proceed a lot of the groundwork will have been done. If the decision is not to proceed, no-one will know it was being considered, limited costs will have been incurred and no-one's expectations will have been raised or dashed.

8.2 Psychological Factors

There are differences between an IS and an External Succession from this perspective.

In the case of an External Succession the Retiring Principal will ultimately be sure to withdraw entirely from the firm, they will have no further input and they will have handed over ownership and control to people who they probably never knew beforehand and almost certainly have no close relationship with.

On the other hand, an IS will inevitably mean that they hand ownership and control to people they have known and worked with for some time. They will hopefully to some extent see those people as friends as well as colleagues and they may well feel a greater sense of obligation towards them.

Furthermore, the Internal Successors probably see the Retiring Principal as something of a Leader and, although they are hopefully very excited and motivated by the prospect of an IS, they may well also be quite concerned about the hole that will be left and whether or not they are equipped to plug it. An external purchaser would have no such qualms, they will want to assume control as soon as the transaction has completed, and they will undoubtedly want the Retiring Principal to be completely out of the picture within a relatively short period of time.

The result is that an IS will potentially place a bit more stress on the Retiring Principal than an External Succession would, and it might take longer for them to extract themselves from the running of the firm. An External Successor would probably be far better equipped to come in and instantly assume all leadership and management responsibilities. With an IS the transition will no doubt take longer, the handover will be much more gradual, more input will be required from the Retiring Principal, and they may find it more difficult to extract themselves finally, and completely, from running the firm.

It may also be that some Retiring Principals want to pursue an IS because they think it will enable them to extract a capital value whilst also continuing to actually play an ongoing role in leadership and management. That is very definitely not the right mindset to achieve an IS because if the Retiring Principal does hang around post completion one of two things is likely to happen:

- If they the right successors are in place, they will probably become increasingly fed up with the Retiring Principal's continued involvement and tensions are almost inevitable. If they arise, they will no doubt be detrimental, they could cause very serious fall out and problems.

- If the wrong successors are in place, they will no doubt welcome that continued involvement, they will probably continue to rely on it and although the Retiring Principal may have extracted capital from the firm, they might find it very difficult to finally leave it behind. In effect the IS might not actually happen. The Retiring Principal is likely to become increasingly less motivated and probably unhappy and the firm is likely to suffer.

Obviously an IS involves the transfer of ownership, control and ultimately all power and influence from the Retiring Principal to other people who that have up to this point viewed as employees who can be told what to do. Even the most magnanimous and collaborative of leaders will have to bring other people into their thought processes and decision making far more than they have done to date, they will have to consult those people, they will have to listen to their views, they will ultimately probably have to accept those views and the decisions those other colleagues make even if they don't agree with them and, potentially, even if they are strongly opposed. In an extreme case the Retiring Principle, if they were a Sole Trader, may have not consulted or involved any of them in any way up to this point.

Some Retiring Principals may find it very difficult to come to terms with transitioning ownership and control over a period of time. They may also find it more difficult to hand over to colleagues, possibly friends, they have known for some time and to treat them as equals rather than subordinates. It is important that all Retiring Principals who are considering an IS take a bit of time to properly consider the implications of this situation.

Right from the start the Retiring Principal must be 100% on board with the principle that the IS will be a sale of their interest, that they will hand over to the successors within a defined time period, their influence will gradually wane, they will end up becoming the subordinate of colleagues who were previously subordinate to them and, at that point, they will walk away and play no further role.

This doesn't mean the IS couldn't lead to a defined, part-time Consultancy role if both the successors and the Retiring Principal want that to happen. But if they do both want that I would suggest that the terms should only be negotiated, and the contract should only be agreed, following completion of the IS and the successors must have complete discretion and control over the terms. Any other approach is likely to muddy the waters as to who exactly is in charge and now running the firm.

It is important that the Retiring Principal who is considering an IS takes a bit of time to properly consider the implications of the proposed transaction. If they don't feel absolutely sure they want to walk away from the firm completely at the end of the transaction, there is probably no point in proceeding any further until they have reached that point in their own mind, because there is a real danger they psychologically still want to hang on in there and that at best could lead to a fraught relationship with the Successor. At worst it could cause a lot more harm that that.

If the Retiring Principal really does want to exit from the firm, but they think they might find it difficult from a psychological perspective to hand over control to colleagues, friends and erstwhile subordinates, then an External Succession may well be a better option. This is because selling to a third party means they will ultimately be boxed into a corner, and once the terms have been agreed they will have very little influence and absolutely no control over the transition. The external purchaser will, without doubt want to take full control of the process and the terms on which the Retiring Principal remains involved.

8.3 Valuation

Valuation will not be determined categorically during the IFS. The process for determining and agreeing the value which the Retiring Principal will receive can only be finalised at the point it is agreed by whomever is going to pay that price, be that the Successor in an MBO or the trustees in the case of an EOT.

But there is no doubt though that, by the time they have got to the point they are considering an IS, the Retiring Principal will have some idea in mind of the capital value they attach to their interest and the price they would like to receive. The aim of the IFS, in this regard, is to determine whether an IS, successfully concluded, will be able to facilitate that price.

The IFS is also a convenient point to check whether the Retiring Principal's expectation is reasonable or, in the unlikely event that they don't have a figure in mind, to give them a reasonable idea as to the value they are ultimately likely to receive.

The starting point is that the Retiring Principal should not go into an IS expecting it will value their interest in any different way, or at any different amount, compared to an External Succession. There is no logical reason why that should be the case. Valuation should ultimately follow the same process under either route as set out in Section 8.

But ultimately it may well be that some external purchasers might offer a higher value, particularly if they believe they can increase profits by making changes to the firm's platforms, investment proposition, systems, processes or staffing levels. It is important that any Retiring Principal who wishes to complete an IS goes into the transaction in the knowledge that they may well not receive as higher value as they might through external succession. Having said that any Retiring Principal who is considering an IS will probably prioritise other factors such as sustaining the firm, protecting their clients and rewarding their colleagues. They may well be averse to wholesale change and be very willing to forego any premium that an external purchaser might offer.

The starting point therefore is either the Retiring Principal's figure if they don't have one or a very quick calculation of potential open market valuation if they don't.

The IFS should then work out, after taking into account the proposed route to IS, the financial position of the firm, the extent to which potential successors can and should contribute financially, the firm's profitability, what borrowing might be available and required overall borrowing capacity and borrowing capacity its borrowing capacity, whether that price and payout are both reasonable and achievable through an IS.

Regardless of what value a Retiring Principal may place on their interest, an IS will only succeed if that valuation is sensible, realistic and acceptable to the proposed Successor. Pretty obviously whomever is buying the interest in an MBO situation will only complete if they think the price is worth paying and they are able to raise any finance required. But furthermore, and particularly perhaps in the case of an EOT, the valuation will need also need to be appropriate from the perspective of HM Revenue & Customs or significant tax complications could arise. If the valuation is unrealistic given the firm's financial position, the Retiring Principal may also never get paid out in full.

The various methods of valuing a firm are set out in Section 8. At IFS stage it is really just a question of checking how the Retiring Principal's valuation stacks up against these principles. If there is a very significant gap between expectation and reality, it will come down to a choice between either selling out now at whatever price an external sale might offer or putting in place a Business Plan which will close that gap and facilitate an IS at the value required. This process for doing that is set out in Section 11.

8.4 People Operations Finance & Time

If the Psychological and Valuation hurdles are satisfactorily cleared, the IFS should move on to considering where the firm currently stands in relation to the key factors which need to be brought together and put in place to facilitate a successful IS. These will differ to some extent depending upon whether the route will be through EOT or MBO but broadly they will fall into 4 categories:

- People
- Operations
- Finance
- Time

Each of these factors needs to be given proper consideration to reach a final conclusion as to whether an IS will be a feasible exit route and, therefore, whether it is worth proceeding and spending more time and incurring more cost to put together a properly detailed Business Plan.

8.4.1 People

Obviously, in the case of an MBO there is a clear need to identify right at the start who the Retiring Principal wants their Successor to be. In most cases the Retiring Principal is likely to have a very clear idea and may well even have very loosely broached the idea with those concerned.

The IS will obviously only be implemented if it has the full agreement of the Successor, and it is only fair and reasonable that they play a full role in putting together the detailed Business Plan and transition process so the IFS should not go very far towards doing that without them. It really is more at this stage about assessing whether a natural successor is in place already or whether they will have to be recruited from outside.

Similarly, if an Internal Successor has been identified and they are in place, it is sensible not to discuss anything which might be construed as a commitment to proceed with them until the Retiring Principal has made a final decision and committed to proceed with an IS.

If it is going to be necessary to recruit a successor this will require a Successor Profile to be put together, a search to be carried out and that successor to be recruited before the IS can go any further. Even if the right person is recruited the Retiring Principal will sensibly require them to prove themselves over a period of time before they can be sure they are indeed a suitable successor. If there is no natural successor in place, the costs and time involved in recruiting one could have a very significant impact on the feasibility of proceeding with a IS. So essentially if the Successor is not actually in place already, the idea of an IS may have to be shelved until they are.

Sensibly, even if the proposed Successor is in place, the Retiring Principal should take a bit of time to consider the effect that their appointment may have on other colleagues. It may well be the case that other colleagues see themselves as more worthy successors than the candidate who has been identified. It could also be that some other colleagues don’t have a particularly good relationship with the person who has been chosen. Obviously, the

Retiring Principal should have a reasonable idea if whether such issues are likely to arise but it is sensible to specifically take a bit of time out to consider whether an appointment could cause any fall out amongst other colleagues and, if it might do that, what the implications might be.

Even if the Retiring Principal is sure they know and understand the personalities involved it could be sensible to ask the Successor to complete some Psychometric Testing to establish that they are as good a candidate as the Retiring Principal thinks, and to investigate whether they have any personality traits that could lead to problems down the line. Obviously, there is no need to give the game away by explaining exactly why the Retiring Principal would like them to undertake such testing, a variety of reasons could be suggested without needing to do that and also without putting anyone in any awkward position.

Other than that, the IFS should sensibly identify exactly what responsibilities the Retiring Principal is currently fulfilling, confirm exactly what attributes are required to successfully perform each one, assess who within the team is currently best placed to take on each one, determine what skills and experience they may be missing and consider what steps will be required, what timeframe will be involved and what costs might be incurred to ensure someone is equipped to take on all the roles and responsibilities which the Retiring Principal has been performing to date, and those which will have to be performed in order for the firm to continue and the IS to succeed.

That plan might involve training which can be sourced internally or externally, it may well involve mentoring and it might also involve coaching. All of these things will take time and they will always have a cost attached either in financial terms or in terms of the impact they will have on business efficiency. The implications need to be very carefully though through at IFS stage. If any of them prove to be disproportionately time consuming or expensive that could have a significant impact on the feasibility of an IS.

It could of course be the case that the IFS identifies that none of the current team can satisfactorily fulfil all the required roles. If that is the case, it will then need to consider how feasible it is to either recruit someone to fulfil them or to outsource them somewhere else. Both options could involve time and cost and again the implications need to be carefully considered.

It is not just the firm's staff which can impact on the feasibility of IS, its client base may also be in point.

It obvious that following any sale, be it internal or external, someone will have to continue looking after the client base after the Retiring Principal leaves the scene. If looking after the client base properly requires specialist technical knowledge, skills or other attributes, or if it is of a certain demographic or based in certain locations or of limited size for example then finding an Internal Successor who is willing to buy in and able to look after it might be difficult.

The difficulty of attracting an Internal Successor could also be compounded if the firm's systems or process are relatively primitive or outdated and in need of significant updating.

Such issue may be of lesser or even no concern to an external purchaser, particularly not to a Consolidator which operates its own investment proposition, platform system and process. Inevitably, and particularly in light of the new Consumer Duty regime a Consolidator will want to transfer all the clients across to its way of doing things. Although these kinds of issues might affect the price a Consolidator is prepared to pay, they probably won't frustrate an external sale to the extent they might an IS transaction.

On the other hand, a well run niche or specialist firm might find it very easy to organise an IS because it would probably provide a very solid base for colleagues to take it on into the future. The Retiring Principal of a firm that deals only with certain types of clients, or which has a particular fee structure might also find it more difficult to organise an external sale even if they want one because an external purchaser may baulk at how different it is.

One way or another, it is important to consider whether a firm's client base or service offering could be a factor in determining whether any potential exit route might be closed or made more difficult or, indeed, whether one option immediately presents itself as the best way to go.

8.4.2 Operations

It is also important to consider the effect of the firm's systems and processes because these can have either a positive or a negative effect on the desirability and feasibility of an IS, and indeed particularly poor systems and processes could also impact on the feasibility of an external sale too.

Obviously most regulated financial advice firms follow the same kind of workflow processes when dealing with clients and managing their accounts, very few are paper based these days and most operate a computerised back office system utilising third party software. But some of those software packages are a bit outdated and limited in functionality and firms can and do use them in different ways. Some use them to their full potential whilst others have limited understanding of their functionality and the efficiencies they can produce, so they don't. Some firms, particularly if they have been run for many years by a Sole Practitioner who doesn't understand or appreciate technology, might still rely far more on paper based processes which have not evolved at all for many years. Paper based systems almost inevitably carry greater business and compliance risks.

The reason why it is important to consider systems and processes is that inefficient ones can significantly impact on profitability, thereby reducing the value of a firm, and bringing them up to date can have significant implications from the perspective of cost and disruption.

Arguably, operational costs are inevitably likely to increase over time and given the FCA's Consumer Duty regime firms will also come under ongoing pressure to ensure they are providing clients with value for money. Inefficient systems and processes will make it far more difficult to so as costs rise, and fees potentially come under increasing competitive pressure, efficient systems and processes will become an increasingly important factor in any firm's success.

If a firm's systems and processes are up to date and efficient that will be very helpful from the perspective of either an internal or an external sale. But if, on the other hand, they need to be updated or totally overhauled, the cost and the disruption involved could impact on the feasibility of an IS and, in a worst case scenario, make the prospect wholly unpalatable to an Internal Successor who will, after all, probably be the one who has to implement the improvements and probably pick up the cost.

From the Retiring Principal's perspective as well as making it more difficult to attract an Internal Successor, a poor or inefficient back office might also reduce the value they receive through an IS considerably because the firm will, one way or another, have to incur the costs and disruption involved in improving it.

So poor and inefficient systems might well sensibly sway a Retiring Principal away from an IS to an external sale. It is very likely, if not certain, to be the case that an external purchaser, particularly a Consolidator, will simply want to switch the clients into its back office systems and processes no matter how good the firm's current ones are.

Therefore, a poor and inefficient back office would be far less likely to deter an external purchaser or lead it to drop its valuation significantly. An external purchaser, particularly one which is planning to switch clients regardless, would probably not reduce the price it is prepared to pay significantly, even if a firm's current systems and processes are very outdated and inefficient indeed.

It is also important to consider that poor or inefficient systems may not actually preclude an IS. An Internal Successor who has worked in a firm for several years is likely to have a very good understanding of how it works, what business has been conducted, who the clients are, what kind of advice has been given and what risks, particularly compliance risks, might be involved. Whether they take the firm on through an MBO, or as a trustee or new director in an EOT they may be quite happy to conduct relatively limited due diligence before they agree to invest or take over the ownership and control of the business.

They may indeed also be quite happy to take on the business either in blissful ignorance of any shortcomings in systems and processes, or in the expectation they will have free rein to make improvements once they have assumed control. Although poor systems and processes will undoubtedly have an impact on profit and valuation, and they might well need time and effort to sort out at some point, they might not prevent an IS from going ahead.

If IS is the preferred route and there are significant shortcomings in a firm's systems and processes, it probably becomes more critical that the intended successor already works within it. This is because although some people are less risk averse than others serious back office shortcomings will probably make it far more difficult, if not impossible, to attract a potential Internal Successor in from the outside. Joining a business with a view to taking it over is quite a risk on its own, having to transform its systems and processes is the process compounds that risk quite significantly and many potential successors could well be put off, particularly if operational matters are not a personal interest or strength.

Any external purchaser, on the other hand, will undoubtedly want to fully understand the nature of the business and particularly any business or compliance risks which it may be taking on when acquiring a firm. If the systems and processes are too inefficient an opaque that might make it very difficult to obtain the required level of understanding. In that case it might also be very difficult to interest an external purchaser, or it might at best significantly reduce the price one is prepared to pay. In extreme cases outdated systems and processes could therefore preclude an external sale and leave an IS as the only feasible option.

So, in summary, the value of the firm and the possibility of attracting any successor at all might be very limited until those systems and processes are improved or at least until the cost and other implications of implementing the improvements have been properly assessed. It is therefore important that the Retiring Principal considers the potential impact of systems and processes on the proposed transaction, in particular whether there will be a need to improve them to get the transaction over the line and what cost, time and disruption may be involved in doing that.

If there is going to be an IS and there is a need to improve systems and processes, then depending upon the firm and the personalities involved it may be better to make them either whilst the Retiring Principal is still involved or after they have retired and left the scene. Only the personalities involved will know the answer to that question.

Another factor which could impact on the desirability or feasibility of an IS could be the firm's investment proposition.

If a Retiring Principal is particularly wedded to theirs this may preclude an external sale, because it would be very naïve to think an external purchaser would not want to make changes in this regard.

Similarly, if the firm operates a very specific proposition and has been banging its drum against all others for a period of years it could look rather odd to clients if the Retiring Principal starts backtracking at the point of retirement and suggesting that an external consolidator's proposition is more appropriate.

Clients placed in that position may quickly become quite sceptical and unsettled and if that happens to the extent they don't agree with any proposed changes and take their account elsewhere that could be disastrous for both the firm and the Retiring Principal's retirement plan.

Therefore, if the proposition is well defined and has been in place for many years, the IS may well be a lot easier route than an external one and this might be particularly true if the current proposition involves particularly favourable charges.

The portability of client accounts and assets is likely to be a significant factor when an external successor calculates the price they are prepared to pay and, almost certainly a significant amount of the consideration will be deferred until those accounts and assets have been switched. In that context a Retiring Principal might have to put a lot more time and effort into convincing clients that an external succession is in their interest. Compared to an IS, there may also be a lot more uncertainty as the price they will ultimately receive for their shares.

A proposition which is perceived as insufficiently robust, poorly performing or relatively expensive may well also be a major deterrent for any future internal successor, particularly as the FCA's Consumer Duty regime comes into force. That regime in part aims to improve transparency on costs and investment performance and it is likely to become increasingly easy for clients to compare both. So, a poor investment proposition will naturally make it harder to attract new clients and could also increase the likelihood that existing clients will transfer their accounts elsewhere. Changing one requires time, effort, cost & knowledge and will inevitably involve disruption. These factors could well deter an Internal Successor but would be far less likely to have any detrimental effect as far as an external purchaser is concerned.

In summary, the more convinced a Retiring Principal is that their proposition is the right one, and the more confident they are in it, probably the easier they will find an IS to be and quite possibly the greater the value they will extract from following that route compared to an external sale.

Conversely if the proposition is not particularly solid, if it doesn't have a good track record, if it is overly complicated or relatively expensive then an IS might be far less attractive, more difficult to get over the line and possibly even infeasible. In this case an external sale might well be the best option, particularly as it might be easier to portray one a being more likely to improve the clients' future experience.

The final factor which might have an impact on the desirability or feasibility of an IS will be the firm's fee structure. Obviously financial advice firms charge fees in different ways but most seem to charge either hourly rate, fixed fees or percentage based fees which are calculated by reference to the amount of capital a client has, or leaves, invested. Different fee structures can obviously have an effect on profitability, but they can also have an effect on both the desirability of the feasibility of an IS.

This is primarily because if a firm offers a particular fee structure which it sees as a Unique Selling Point, and which has been a foundation of its marketing campaign, then either the Retiring Principal may be very keen to continue it or it might practically be very difficult for to facilitate an external sale which would change it.

This is particularly true if the particular fee structure has been one of the key reasons why the clients have chosen to engage with the firm. Probably the prime example of where this situation might arise is if a firm charges fees on the basis of time spent on each client or on the basis of hourly rates, because both approaches are both crucially important and attractive to some clients, but they are rarely offered by financial advisers. Both approaches necessarily involve maintaining clear and accurate time records and that, in turn, requires both an appropriate time recording system and a very disciplined approach from the Adviser and the support team. It takes time and effort to instil the latter so if firms charge fees in these ways an IS could well be the only feasible option unless all parties, including the clients, are prepared to accept significant change to their fee structure.

An external purchaser will probably have its own ideas on how fees should be calculated and charged and if a firm does offer one of the less common fee structures such as hourly rates or fixed fee that might well be a barrier to an external purchase. This is likely to become even more so under the new Consumer Duty regime as external purchasers, especially Consolidators of IFA firms, will undoubtedly come under pressure to homogenise their fee structures across all of the firms which they have acquired.

Therefore, an external purchaser will probably only be interested in acquiring a client base if it can easily convert to its own fee structure, if the firm's current fee structure is significantly different that could make an external succession very difficult, especially if the firm's current fees work out lower than those a purchaser may wish to charge.

On the other hand, if the firm's current fees work out considerably higher than an external purchaser's that might make it a far more attractive proposition. It is worth noting though in this scenario an external purchaser might want to value the firm on the basis of its, rather than the firm's fee structure because the Consumer Duty regime will expect it to bring all clients fees into line post acquisition so any relatively higher fees which are currently charged might have to be reduced. The corollary of that is that if the firm is currently able to charge relatively high fees, an IS might well produce a higher value from the Retiring Principal's perspective.

In summary, if a firm does offer a particular fee structure which is different to other financial advisers, if it has been a fundamental factor in the current clients' decision to engage or if the Retiring Principal is particularly keen to retain it, then an IS might be the more appropriate way to proceed. If the firm charges higher fees than most this could make an IS the most financially rewarding route for a Retiring Principal.

If the firm's current fees are lower than most an external succession could result in a higher price for the Principal, but only if they accept that clients' fees will probably increase as a result. If they believe an increase in fees is appropriate and will be acceptable to clients that begs the obvious question, why haven't fees been increased already. There is also no reason why an Internal Successor couldn't increase fees in the same way an external purchaser could if that is the appropriate and acceptable thing to do.

8.4.3 Finance

If a Retiring Principal sells his shares to an external purchaser, it is of no concern to him how that purchase price is funded but, if his exit is being facilitated by an IS, it very definitely will be.

Getting any exit plan over the over the line is not the only factor involved. The Retiring Principal is likely to be equally focused, if not more focused, on how long it will take for them to be paid in full for the value of their interest.

If the price is reasonable there will be little doubt that it will ultimately be achievable through either a sale to an external buyer or an IS. But, although an external purchaser, particularly a Consolidator, will almost inevitably have cash available, the price in an IS has to be funded, one way or another by a combination of the Successor's financial contributions and the firm's profits and cash resources.

Very importantly, because the whole aim IS is to enable the firm to carry on trading into the future, the financing of an IS must take into account the financial requirements of the firm itself and make sure that it is always left with the cash it requires to pay its staff and its expenses. If it isn't obviously the firm will have to cease trading and the aim of the IS will be totally defeated.

An IS, as indeed will an external sale, will almost certainly mean that the Retiring Principal will be paid by instalment. So, regardless of whether the preferred route is EOT or MBO the IFS should aim to establish the time period over which the Retiring Principal can expect to receive payment, what instalments are likely to be affordable and with what regularity they can expect to be paid.

In the case of IS, the purchase price for the Retiring Principal's shares will have to be largely funded by internal resources. In the case of an EOT it will almost certainly have to be funded exclusively from the firm's profits, if an MBO is involved it will be partly funded by the successors themselves and debt finance will almost certainly be a further option. But either way, if the Retiring Principal wants to be sure they will ultimately be paid for their shares, it is critically important they establish that an IS will be able to fund the price which they require.

There will be a limit on the amount an Internal Successor and a third party debt financier are able and willing to contribute. The crucial starting point, therefore, is to establish exactly what the firm's future profits are likely to be, over what period of time, to what extent they need to be ploughed back into the firm to enable it to carry on running and hopefully growing and, therefore, to what extent they can be diverted to pay the Retiring Principal.

That in turn brings us back to the need to prepare a realistic Business Plan. Hopefully the firm will already have one but, even if it does, it probably needs to be adjusted to account for the impact or the Retiring Principal's retirement.

If no Business Plan exists, then because it is impossible to understand properly whether an IS is either desirable or feasible without one, at least an outline Business Plan will have to be compiled before matters proceed any further.

The content required and the steps involved in bringing one together are considered in Section 11 below.

At the IFS stage the plan can only be put together as an outline in order to help the Retiring Principal frame their thoughts, as a tool to assist with valuing their interest and, most importantly to create a proper foundation for discussing the IS proposal with the proposed Internal Successor.

Once the outline Business Plan has been put together it should be clear what profits the firm will be able to contribute over what period of time. It is obviously though important to emphasise that even the best laid plan will necessarily have to be based upon assumptions and future projections and in either case reality could turn out to be very different to expectation. There is no guarantee even the best laid plan implemented by very capable people will be achieved.

Obviously, at the end of the day the terms of an IS will be enshrined in a contract to which all parties involved will agree to be bound, but if those terms ultimately turn out to be overly ambitious it will be difficult for the Retiring Principle to enforce them, unless they are happy to take action against both their firm and their ex colleagues, in the knowledge that doing so could have a catastrophic financial effect on both.

That potential issue aside, If the transaction is going to proceed as an EOT the Retiring Principal will be left with a very clear idea of how long it will take for the trust to purchase their shares at the price they intend, and what frequency and value of instalments they can expect. That will hopefully be acceptable but if it is not then an EOT will not be the appropriate way to proceed.

If an MBO is the preferred route the Business Plan will obviously again quantify the extent to which profits can fund the transaction. It should also enable what level of contribution should be requested from the successor colleagues who will be invited to purchase shares at the next stage.

Obviously at this point these successors will not have been brought into discussions and it is impossible to know how they will view the level of contribution required from them. It is entirely possible they may baulk at the contribution required when they know it but hopefully the Retiring Principal's knowledge of their colleagues circumstances might give them some idea in this regard.

If the Internal Successor is going to have to be recruited it will at this point be possible to clarify how much they would be expected to contribute so any head hunter involved can frame the proposal they will be putting to any suitable candidates they may identify.

If the outcome of these calculations is that an MBO will enable the Retiring Principal can be paid the value they think is reasonable over an acceptable period there is no pressing need to seek any debt finance.

But, if the Retiring Principal would like to be paid over a shorter period of time than the figures indicate is likely, they should now have all the information they need to initiate discussions in principle with external debt financiers. It should not take long for those financiers to decide how much they may be prepared to lend on what terms. Once those are known the Business Plan can be updated to establish the feasibility and implications of part financing through debt.

8.5 Time

The result of considering how the firm is positioned in terms of People, Operations and Finance should be that the Retiring Principal has a very clear idea of where the firm is currently positioned in relation to where it needs to be for the IS transaction to succeed. Any gaps which need to be filled should be pretty evident and the action which is required to fill should be pretty clear too.

So, at this point the Retiring Principal should also have a skeleton in mind of the steps a detailed transition plan will need to take and the order in which they will need to be taken. Naturally that gap analysis combined with the financial analysis will then also give them a pretty clear idea of the time horizon which is likely to be involved in bringing the IS to a conclusion and how long the transition period will need to be.

The IFS basically needs to establish two time horizons:

1. The Transaction Point - how long it will take to complete the IS Transaction itself, which will essentially define the point at which the Retiring Principal will be able to exit the firm and retire and

2. The Consideration Payment Period – the stages in which the Retiring Principal will receive payment for their interest in the firm, giving a reasonable idea of both the amounts and the dates involved

Both timeframes must obviously be acceptable to the Retiring Principal for an IS to be feasible.

8.6 The Decision to Proceed

Once the IFS has brought together all the strands set out above in this Section, the Retiring Principal should have sufficient information to enable them to decide whether exiting the firm through an IS will meet their expectations in terms of the value they receive and the time period over which they will receive it.

It should also give them a much clearer picture of the work that will have to be done by them and others to bring the transaction to a successful conclusion and how much time and cost will be involved.

The decision to proceed or not is entirely theirs. They should take, within reason, whatever time they feel they need to reach it because once they go beyond this point, they will be bringing other people into their confidence, they will be putting in time and effort and they and the firm will be incurring cost. At this point they will need to be 100% committed to seeing the IS through to a conclusion and if they are not the chances of a successful conclusion are very unlikely.

Once the Retiring Principal is committed to an IS, the next, and very important step is for them to bring the successor, assuming they are already employed, into their confidence because now is the time to establish their views on the IS and to check they are happy and to proceed along the lines which have been loosely defined in principle at this point.

That will involve obviously direct discussions with the proposed Successor under an MBO or, if an EOT is chosen as the preferred route, it will involve discussions with the proposed trustees and directors.

In either case those people should know pretty quickly whether they wish to proceed or not, but it is important they are given whatever further information they require at this stage and equally they should not be rushed into making a decision. It is obviously going to be vitally important that they are 100% committed to the concept of IS. They will rightly both require and need some time to consider the invitation they have received and to reach their own decision in the same way the Retiring Principal did theirs.

There will hopefully not be any need for the Successor to undertake any detailed due diligence before they fee able to reach their decision. They should already have a good understanding of the firm and sharing the output from the IFS should hopefully provide all of the information they might require.

If the successor is not employed the next step will be to find them, but at least the IFS will have equipped the Retiring Principal with all of the information they will need to brief both a head hunter and a potential candidate as to the terms of the IS they are proposing and over what timeframe they would expect it to happen.

9. Agreeing the Sale with the Internal Successor

Once the Outline Business Plan has been compiled and the Retiring Principal has concluded that an IS is the way to proceed and determined which route they would like to follow, the Outline Business Plan and the IS proposal can be shared with the proposed Internal Successor.

Hopefully the discussions which then follow will be that the proposal is accepted by the successor, and all parties are clear in their own minds that they want to proceed, the transition to the new ownership can begin.

The first step in implementing an MBO is that the successor should be asked to purchase a minority stake in the firm, and they should be required to pay for it with cash.

The purpose of selling a minority stake to internal successors is to ensure they put “skin in the game” and also to align their financial interest very definitively with that of the Retiring Principal. Because both parties are now part owners of the business this also creates not only a common interest but also some degree of accountability between them.

The fact that the successor has had to contribute cash, which is now at risk if the firm fails, really should focus their mind and their efforts. In exchange for contributing that cash and becoming a part owner they are also now fully entitled to be brought into the Retiring Principal’s thought process and decision making, they will be entitled to express and to have their views heard and, if the Retiring Principal is sensible and really committed, they will take those views into account.

The IFS and outline Business Plan will have identified the starting points for these discussions about what personal financial contribution will be expected in exchange for what level of minority shareholding, but it will probably take a little while for the Successor to work out what amount they can feasibly afford to contribute and possibly to arrange the funds required.

It is also important to note they may not be able or willing to meet the Retiring Principal’s expectations in this regard. If they are not the discussions might need to be a bit more protracted than originally thought and it may be necessary to agree a compromise. If a compromise is necessary, but one can’t be reached then obviously it might become necessary to rethink the strategy entirely.

Assuming that the Successor does buy in to equity, this will demonstrate true commitment to the firm on their part. It also turns them into a true stakeholder in the future success of the business and it gives them a moral right to be involved in management responsibilities and decisions from now on. Although their legal rights will depend on the structure of the firm and the extent to which they have bought in, this should give the Retiring Principal confidence that they are in for the long term and that, amongst other things should encourage them to involve the new participants in the leadership and management of the firm.

If the Successor has purchased shares from the Retiring Principal they have also received the first tranche of the cash they are due in payment for their interest. Apart from the fact this obviously gives them some funds to do whatever they wish with, it also reduces the amount that will have to be found from the purchasers or the firm’s internal resources, or the amount of debt which will be required to bridge any funding gap.

Alternatively, it may be preferable for the Successor to subscribe for new share, in which case the cash they have contributed belongs to the company and can be used if required to meet any costs involved in implementing the Business Plan.

These two different options can involve different tax implications and it is important that the decision as to whether the Successor purchases new or existing shares is reached after taking professional tax advice.

In either event, by bringing the Successor into ownership alongside them, the Retiring Principal has taken the first step towards sharing control and delegating responsibility. They will now have at least one equally committed senior team member supporting them and they should be very keen to help share in the implementation of the Business Plan and in the ongoing leadership, management and development of the firm. The Retiring Principal can now begin the process of devolving those responsibilities gradually without ceding control.

If, on the other hand, the IS will be going down the EOT route, no-one will be expected or required to contribute cash, but it will be necessary to set up the trust itself, to determine who the trustees are going to be and who is going to take over responsibility for the leadership and management roles which the Retiring Principal has performed to date. Even in this case the Retiring Principal is likely to need help with implementing the transition and it is going to be necessary to ensure that successor Directors who are capable of running the firm are in place.

Whether the IS proceeds through an EOT or an MBO, as soon as the Successor has been tied in with their initial shareholding and all parties interest are aligned, this also creates the solid platform required to begin the transition leadership, management and client responsibilities from the Retiring Principal to whomever is going to take them over.

What it also does, because shareholders have rights, is require the Retiring Principal to bring other parties into their thought process and decision making. They must recognise that they are no longer in full control, even if they have been to this point a Sole Trader or sole Shareholder, and the sharing and delegation of control and responsibility now absolutely has to begin.

And finally, the Retiring Principal has also taken a psychologically important first step towards the door. That is very often the most difficult one to take and the fact that they have taken it will hopefully encourage them to look forwards to the day they will finally exit the firm and begin to hopefully enjoy their retirement.

The steps required to see that transition through to a successful conclusion, and the time which is required to take them will obviously vary from firm to firm. But in all cases the outline Business Plan which was established during the IFS phase, and which will now be reviewed and refined should provide a very clear path through to completion.

Obviously even the best laid plans can be thrown off course. So it is very important that progress against the plan is regularly reviewed. The best way to do this is to establish formal meetings which review progress, identify where it has, or it may, come off the tracks and identify and allocate responsibility for the action required to make sure it gets back on them. As well as significantly reducing the risk of failure these meetings should also, as long as they are properly and sensibly conducted, really help enhance the team spirit and the sense of a common goal and collective responsibility for achieving it.

Whichever route is being followed, the transition of ownership and control will best be achieved gradually. From the Retiring Principal's perspective, they have the comfort of knowing their successors have committed their futures to the firm and they can share the benefit of their experience with confidence. But it is also clearly now in their best interest to support their Successor and encourage them to come through and pick up responsibility for managing the firm.

A gradual phasing out of ownership and control might also make the process far easier and more pleasant and significantly less traumatic for the Retiring Principal. If anything, once they have experienced the load being taken off their shoulders they will probably begin to relax and enjoy life more. A gradual transition may well make the end of their working life and their retirement much more relaxed and enjoyable than it would be if the transition were made more abruptly.

Because a gradual transition will enable the Successor to assume leadership and management responsibility in stages under the oversight of a Retiring Principal who is motivated to make the transition a success, it should also be a more enjoyable and a safer approach for the Successor compared to the experience of taking control very quickly. They should also feel confident and well equipped that they have acquired all of the knowledge and at least some of the experience required to take the firm on to future success.

The final crucial point about a gradual transition of ownership is that it is probably far less disruptive and far more encouraging as far as clients are concerned. The Retiring Principal is likely to manage some key client relationships, they can take time to work out which of the new owners is best suited to each client and to personally hand over the responsibility whilst remaining in the background should the successor adviser need any help, support or guidance as they bed into the client relationship.

Obviously, the true value of any financial advice firm, from both the Retiring Principal and the Successor Colleagues ‘perspective, is its client relationships. If any change of control proves disconcerting for clients there is a very real and obvious risk that they will remove their accounts and investments, thus decimating the current and future value of the firm. Restrictive Covenants are not an adequate tool to try and force clients into staying put if they wish to seek advice elsewhere.

Logically most clients should be encouraged by the fact that a transition is in hand and that a new ownership team is being put together from people who already work for the firm and who have the trust and confidence of the Retiring Principal. If the Retiring Principal is approaching retirement age most clients will obviously be aware that their retirement was on the cards, and it is far better for all concerned if the firm takes the initiative as regards succession rather than wait for the clients to start prompting it.

A gradual transition done well will naturally be less disruptive for clients, it should logically reduce, and it will probably eliminate, any risk of unnerving them. As long as the handover goes well and both the Retiring Principal and the succeeding Advisers are aligned to achieving the same common goal of a smooth, efficient reasonably timely and comprehensive transfer of control, a gradual transition should pretty much secure the firm’s critically important clients, ongoing fees and staff, and therefore achieve a good result for all participants and other stakeholders.

One other important factor is that taking a gradual transition in an MBO situation will also no doubt make it far easier, and potentially cheaper, to raise external dent finance to complete the buyout if that is part of the plan. That is because the Successors should be able to show any lender that they have built some management and leadership experience through the transition phase, that all clients are fully on board and all fees are secured. Building relationships with potential financiers and getting to know them gradually should be an important part of that plan because that is likely to increase a lender's confidence in those who are taking the firm forwards and that can have a favourable impact on both the lending decision and on the terms at which finance is offered.

10. Valuation

Fundamentally any firm is worth what a proceedable buyer is willing to pay for it, and obviously for an IS to work, there must be agreement on between the retiring principal and the internal successors on that valuation.

The Retiring Principal may be happy to offer an Internal Successor a discount compared to what an external buyer might pay in order to achieve their objective of an IS, to recognise the contribution made to date by the successors and possibly also to make the purchase more affordable. The internal successors might also expect a discount in order to fairly reflect their work and contribution to date.

But there is no reason why a valuation should be discounted in principle. That is a matter for the Retiring Principal to consider, and ultimately for negotiations between buyer and seller to determine. Given though that any negotiations around price obviously have to have a starting point, the sensible way to start, in fairness to all parties, is to calculate the open market value of the firm and go from there.

Calculating open market value is not, however, as easy as it may sound. Given the current state of the market there are several potential buyers out there, each of whom would apply their own criteria and consequently each reach their own individual valuation.

Valuation methodologies fall into one of three main methodologies:

- Book Value
- Relative Value
- Intrinsic Value

Each of these is described below.

10.1 Book Value

Book Value is probably of little relevance. It values a business on the basis of its assets less its and liabilities ignoring what is in accounting terms known as goodwill, which is effectively the shareholder value which the business thinks it has created by combining and working those assets and liabilities.

Book value is therefore simply the realisable value of the assets the firm owns less the value of any liabilities it has to pay. It really only has relevance when a business is in distress and needs to be rescued, or if it appropriate to calculate what value might be extracted if the business was wound up and ceases to trade.

Obviously, neither of those scenarios are likely to apply in the context of an IS, which is why this valuation method is almost certainly irrelevant.

10.2 Relative Value

Relative Value is probably the appropriate methodology for valuing any business which is being acquired as a going concern with a view to maintaining its trading status for the foreseeable future.

It is a relatively simple calculation which starts by identifying whichever performance factor the purchaser thinks is relevant and then applying a multiplier to them to derive what is felt to be an appropriate valuation.

On this basis valuation would be calculated as follows:

Valuation = Performance Factor x Appropriate Multiplier

More than one performance factor can be identified each one might well require a different multiple to be applied.

Historically, it has often been the case that the key performance indicator in financial advice businesses has been recurring client fees or the value of client assets which fall under the influence of the firm. Some Consolidators still appear to value on that basis and there is certainly at least one out there which offers to purchase client banks for a percentage of the value of the investment portfolios in question.

History shows that these valuations are often opening offers which are heavily dependent upon the acquired firm both switching them into the acquirer's investment proposition and administration platform, adopting the acquirer's fee structure and retaining the client fees for a period of time.

Clearly such valuation bases are nonsensical from the perspective of an IS because the key objective in this scenario is to maintain the current investment proposition, service offering and fee structure, at least in the short term. They are in fact also nonsensical from the perspective of common sense because they completely fail to take any account of costs involved in servicing those clients and maintaining the fees.

Because of that they are very definitely not the best measure of value of an IS. The most appropriate performance factor in an IS scenario is profit, more specifically the Earnings Before Tax Interest Depreciation and Amortisation ("EBITDA"). This figure also represents the day to day "Operating Profit" of the firm – its total income, less the direct costs involved in generating that income, which are the costs of employing the people involved and the overheads of running the business. It is effectively a measure of the firm's profitability and ability to generate cash flow before taking into account any financing costs, taxation and accounting adjustments.

The accounting adjustments, Depreciation and Amortisation aim, in simple terms, to spread the cost of any major capital assets over the number of years which they are in use within the business. Depreciation applies to tangible assets (ie those you can see and touch) and Amortisation to intangible ones (ie those you can't see and the main example is likely to be Goodwill which is usually another accounting adjustment created to value the implied benefit of a previous business acquisition).

Very few financial advice firms own significant capital assets, if there is any Goodwill on the Balance Sheet it is effectively a subjective "paper" which has no intrinsic value. It makes perfect sense to ignore both in valuing the firm.

Interest is ignored because it is a finance cost, which depends on how the previous owner has decided to finance the business. Any debt which has been taken out by the previous owner could well be repaid on completion of the IS, particularly if it is owed to the previous owner, the business may not actually need any debt finance or the future owners could decide to refinance the firm in a very differ way. The true value of a business is in its ability to generate profit and how it structures itself is of no real account. Therefore, it also makes sense to ignore any interest costs when ascertaining its true intrinsic value.

Finally, tax, although inevitable, is not a direct cost to the business, it is a charge levied on profit by the state and neither the firm nor any of the parties involved in the IS can have any significant influence or control over it. Furthermore, the rate can, and very likely will, change regularly in future years.

So, EBITDA effectively measures the true profit generated by the firm's day to day operations, it considers both the income which the firm generates but also the direct costs involved in generating that income. Another way to look at it is it is effectively a measure of the firm's efficiency, and, as long as no material changes occur to those incomes or costs, it should be a reasonable measure of sustainable future profits and therefore its ability to generate a net income for its new owners.

The second step involved in the defining valuation is the application of an appropriate multiplier. This figure will necessarily be a more subjective and this is likely to involve a more subjective assessment. The multiplier effectively represents the number of years that it will take for the Operating Profits of the firm to repay the new owners the price which they have paid to acquire the firm.

Broadly speaking, the larger and more sustainable the Operating Profit the larger it is reasonable to expect the multiplier to be. In the current climate a multiple of between 4 and 6 times would probably be appropriate for most small firms, depending upon the quality and sustainability of the client bank, and up to about 10 could be reasonable for a relatively large, well established, profitable firm with a good client base, particularly if the retiring Principal has created some good potential growth opportunities for their successor which can be grasped without taking on further material costs.

10.3 Intrinsic Value

The intrinsic value of any business is essentially the value of the money which it is expected to generate for its owners over the period which they own and operate it, discounted to reflect the fact that money generated at some point in the future is of lesser value than one generated today.

Most financial advisers should be familiar with the concept of Discounted Cashflow, it is an investment valuation technique which is included within all the Professional Exam syllabuses. It involves (a) ascertaining the sustainable future net cashflows which will be produced by the investment and (b) applying a discount rate to those cashflows to reflect their current value, at this point in time, given the particular attributes of the investment.

Ascertaining the appropriate discount rate is likely to be the most difficult part. In the case of a business, it is likely to be its Weighted Average Cost of Capital (WACC) which represents how much it costs the business to access the capital it needs to finance itself and its activities. The weighted average tales account of the fact that capital in most cases, particularly in the case of a firm which goes through an IS, is going to be provided by a combination of the shareholders paying for shares and the firm borrowing money from some external party.

In other words, WACC reflects the rate of return which the shareholders require their investment to produce and the rate of interest which any debt financiers require to be paid.

Valuation on a Discounted Cashflow basis is calculated as follows:

$$\text{Value} = \frac{CF1}{(1+R)^{\wedge}1} + \frac{CF2}{(1+R)^{\wedge}2} + \frac{CFn}{(1+R)^{\wedge}n}$$

Where

CF1	is the net Cashflow generated in Year 1
CF2	is the net Cashflow generated in Year 2
CFn	is the net Cashflow generated in future Years (a calculation for each year)
R	is the appropriate Discount Rate

If for example the new owners expect to own the firm for a further 20 years, it will be necessary to do a total of 20 individual calculations, one for each year, and the resulting valuation will be the sum of those 20 figures added together.

Performing this rather more detailed calculation is a very useful tool to check against the valuation derived by multiplying the EBITDA. Effectively what it shows is what is the maximum valuation which should be applied to the firm in order that the new owners can expect to make a positive return on their investment in it, after taking account of the cost of the capital which they subscribed to buy shares and any debt which they need to borrow in order to complete the purchase.

If the IS is going to be structured as an MBO it is important that the valuation basis which is adopted when the Successor acquires a minority interest, is carried through and applied consistently at completion.

Applying two different valuation bases at these two different stages will almost certainly cause ill feeling. For example, if the Successor initially bought it at a 6 x multiple of Operating Profits and is then expected to complete the purchase at 8 x, they would probably, and quite justifiably, feel aggrieved that their reward for their efforts during that interim period is simply that they are being asked to pay disproportionately more to complete the purchase.

10.4 Practical Points on Valuation

When it comes down to it, any initial valuation, no matter how it has been calculated will involve a degree of subjectivity and it should really be viewed as a starting point for discussions between seller and buyer.

The ultimate and true value of any business depends upon the price which a buyer is prepared to pay and that which a seller is happy to accept. It is very common for a seller and a purchaser to each take separate advice on valuation and for a variety of calculations to be prepared in order to come up with a range of valuations within which negotiations can be conducted to finalise and agreed figure.

One key difference between an IS and an external succession is that in an IS situation the range of potential buyers is very limited and could, in the case of an MBO, be restricted just one person. That can, and very likely will, impact both the valuation and the scope that there is to negotiate around it.

In the case of an EOT it would be sensible to assume that HMRC could scrutinise the valuation at which ownership has transferred to the trust. The legislation involved requires the transfer of ownership to be completed at the "price which the asset might be expected to fetch on a sale in the open market". Valuing on a sensible multiplier of Operating Profit should not cause any issues but HMRC is well aware the a Retiring Principal could seek to over value. It is also worth pointing out that if the trust purchased at an excessive value that could place the trustees in breach of their fiduciary responsibilities.

Any retiring principal who wishes to exit through an MBO the seller must clearly accept these parameters and, logically, they must also further understand and accept that in the case of an MBO an open market valuation (ie the price the highest potential bidder in the market is prepared to pay), is actually quite irrelevant. The value of the firm is limited to the price which their chosen Successor is prepared to pay.

Furthermore, unless that Successor is awash with cash, the value is also going to be limited to the price which they can afford to pay. That in turn will be limited to the amount of funds they are able to subscribe from their own personal resources, and a combination of the firm's ongoing profits and the maximum amount of finance they are able to borrow in order to complete the purchase.

Logically therefore a sensible initial step to take towards valuing a firm for the purposes of an IS, is to start by ascertaining what amounts the potential successors will be able to contribute themselves (which may to some extent depend upon their personal borrowing capability), and what maximum amount an external financier would be prepared to offer to them given the financial position and outlook for the firm.

In principle two forms of finance could be considered:

Equity Finance, which basically means selling an interest in the firm to an external financier on the basis they will expect to have future input into its leadership and management and a share of the profit which results.

The potential advantages are a) that the firm has no firm commitment to repay the finance which can obviously be helpful from a cashflow perspective in the short term, and (b) the financier's involvement in leadership and management could provide the Retiring Principal and Internal Successor with useful additional support and ideas, on the basis their financial interests are very much aligned.

The potential disadvantages are principally a loss of full control and influence over the leadership and management of the firm and an expectation that the equity financier will be entitled to a fair share of future profits.

Debt Finance, which simply means borrowing the finance on predefined terms which will set out the interest rate, the term over which the loan will be repaid, the repayment schedule which will have to be met and any security which is taken, from either the firm and/or the parties involved in the IS.

The advantages and disadvantages are effectively opposite to those of equity finance in that there will be no loss of influence or control and no sharing of profits, but on the other hand the firm will need to pay the loan repayments on time, which will be drain on cashflow, and if it fails to keep up to date with those repayments the consequences could obviously be severe.

It is very unlikely that any equity financier would settle for a minority interest in the firm over the long term. Almost certainly funding would only be offered on the basis that it is a step on the way to purchasing a controlling interest.

If the Retiring Principal is prepared to contemplate that sort of deal, they would probably be best advised to go straight to an external succession in the first place. So, almost inevitably, in an IS situation debt finance is likely to be the only viable option.

Clearly, before any lender decides what it will be prepared to lend, it will have to also form a view on the firm's current financial position and the adequacy of the security it offers but also, more importantly, how it is likely to perform financially in the future under its proposed new ownership.

Debt financiers are obviously very experienced in assessing the ability of firms to repay debt, their methodology is both philosophically aligned those of the parties involved and because it is also based on sound business principles, dispassionate and effectively independent it is also very likely to represent a very fair and reasonable basis for negotiations between the retiring principal and the proposed new owners.

In the current climate it is likely a financier would cap a loan facility at 6 times what it believes are the established and sustainable profits. This amount, added to the amount of "skin in the game" which the Successor has contributed probably sets the maximum value which the Successors can afford to pay as an initial contribution, obviously any balance of the purchase price could be paid by instalment, as long as the firm continues to make profit after meeting its operating expenses and servicing any debt it has taken on.

What an offer of finance will also obviously indicate is the interest rate at which the lending will be offered. If they are sensible the Successor will expect to earn a higher return on their investment over time because the lender will have to be repaid first before they receive any return themselves. The shareholder takes the higher risk and so deserves a higher return.

Those two rates then provide all of the information required to calculate the WACC and therefore set the discount rate for the important “check and balance” Intrinsic Value calculation on the basis set out above.

11. The Business Plan & Financial Control

Regardless of whether the IS proceeds as an EOT or an MBO a proper Business Plan is going to be a critically important part of the strategy and a successful transaction is very unlikely to happen without one.

As even the best laid plan is of limited value unless it is accompanied by a proper process for monitoring progress against it, for identifying where progress is falling short and for identifying and taking the action required to close those gaps. It is equally important that a process for monitoring performance against plan and taking action to stay on track is also put in place too.

In the context of an IS the Plan will probably be produced in two stages:

- Initially an Outline Plan will give the Retiring Principal a proper framework for deciding whether an IS is feasible and the way to go.

- Once the decision to proceed with IS has been made and the Internal Successor is on board, it will be appropriate to review the Outline Plan, to invite the Successor to contribute their views and for both the Retiring Principal and, more crucially, the Internal Successor to agree the final fully detailed version.

Hopefully, because the Internal Successor is now fully bought in, they will be adding some impetus and enthusiasm to the original plan.

They may have thoughts which could result in increasing the fee income expectations from the expectation set by the Retiring Principal. The other obvious risk is that they would like to add some further costs into the mix as well.

Sensibly the Successor will understand that the priorities at this stage have to be ensuring that any debt can be serviced and that the Retiring Principal gets paid out. Even if they don't it should hopefully not be too difficult to instil that discipline. They should realise that once the Retiring Principal has been paid out and has left the scene then, subject to ensuring any remain debt is serviced, they will have pretty much free rein to develop the business as they wish.

There is an obvious danger that the Internal Successor's view on income and costs might differ from those of the Retiring Principal and there is no doubt that the Budget will have to be an agreed compromise between them. This is actually a good thing because it means they will have to hold those discussions at a very early stage in the proceedings.

Hopefully they will reach full agreement because if they don't the IS will be derailed and potentially ruled out altogether. But, because their interests are now broadly aligned, and they all have something at stake the chances are they will reach agreement. If they don't and they can't be reconciled, this will at least become apparent at a very early stage in proceedings with the obvious benefit not too much time and effort will have been wasted if they decide they can't make the IS work.

This final Budget will also determine, if appropriate, how much finance is going to be required, if any, to finance the IS, when it will be required and it will include all the financial information any lender will require in order to reach a financing decision.

The debts owed to the debt financier and the Retiring Principal could obviously be quite significant and no business can ever guarantee it will hit Budget because no matter how well the plan is drafted unforeseen events can occur and probably will. For this reason, the final Budget needs to be properly stress tested to check the repayments will still be affordable even if the firm experiences a period of poor trading conditions.

A properly put together Budget will also ensure both the Retiring Principal and the Successor have a reasonable idea of what minimum income the firm needs to generate. It will also to some extent being to consider what alternative courses of action might be available if the firm looks like income might fall below that level.

Reviewing the Outline Business Plan and enshrining the final version is equally important even in the case of an EOT where it is unlikely any external borrowing will be involved or any funding gap to plug. Even if there is no need to secure external debt funding it is still vital that all the parties involved understand the financial position of the firm, what fee income it is expected to earn, what level of working capital it will need to meet its day to day cashflow requirements and therefore what surplus profits will be available to either pay off the Retiring Principal or in due course facilitate any bonus payments to staff.

The aim at this stage is now to get the Plan into the best possible shape so it presents the IS transaction in the best possible light to the other Stakeholders involved. It can be invaluable in gaining the confidence and buy in of key clients and colleagues, but it will be vitally important information for any debt financier, and it will be one of the key factors on which any lending decision is based.

11.1 What Business Plan is and why it is important

The Business Plan is essentially a document which describes, in detail, what a company is about, its objectives for the future and how it plans to achieve them. It also effectively lays out a road map for the firm from the perspective of business development, operational development and, crucially it also sets out the financial implications of putting the plan into action and what the firm's financial position will be when the plan has been achieved. It is aimed at both a company's internal and external audiences.

Without a Business Plan a firm has very little control over either its direction or its destiny. These days, particularly as the regulatory burden is getting ever more complicated, cost pressures are increasing, and it is becoming ever harder to attract and retain good quality staff a firm has to grow in order to survive. If it doesn't it will inevitably find itself becoming increasing less profitable as costs increase and the client base naturally contracts. The problem cannot be resolved by simply increasing fees because in an ever more competitive, Consumer Duty based, environment there is a probably a limit to the fees which both clients and the FCA will tolerate.

Without a properly comprehensive, sufficiently detailed Business Plan it will be impossible to obtain the finance an MBO will almost certainly require.

Although funding may be irrelevant in the context of an EOT, it will still be necessary to demonstrate to the firms Stakeholders that the IS has been properly thought out and the firm will continue. No doubt the Retiring Principal will also want to be sure the firm will be able to pay them the consideration due to them over an acceptable period of time. It might also be necessary to show HMRC such projections in order to secure the favourable tax treatment which the Retiring Principal expects.

Finally, an IS will inevitably involve a Change of Control from the FCA's perspective and that in turn will very definitely mean the FCA will want to be sure that the firm will continue to meet the Threshold Conditions which apply to all regulated firms.

Amongst other things meeting those Conditions will require the new Controllers to show the FCA that they fully understand the nature of the firm's activities, that it has access to sufficient resources to ensure it can undertake those actives into the future and it particular that it will be able to meet ongoing minimum capital requirements. The FCA actually suggests that when a firm submits an application for change of control it "may wish" to submit a Business Plan which covers certain key aspects and, helpfully, it goes on to suggests what information it thinks should be included. It would be interesting to see whether approval would be forthcoming without one.

So, for various reasons, a properly drawn up Business Plan is vitally important to any financial advice firm that wants to exist in the longer term and particularly to one which wants to complete an IS in the short term.

It is equally important to any Retiring Principal who wants to maximise the value they receive on retirement and for any Internal Successor who takes the firm on so they can assess exactly what they are getting themselves into, regardless of whether they are doing it as shareholder, director or trustee.

In the context of an IS, the Business Plan will be crucially important in defining and quantifying the path to a successful conclusion, it should generate confidence amongst the workforce on the way and it should tie everyone who works within the firm to a common goal and encourage collaboration in the process of achieving it.

From the Retiring Principal's perspective, it should also confirm how and when they can expect to be paid out. From the perspective of the other parties involved it should also assure them that the price at which the shares were exchanged is fair and reasonable to all. Crucially the Business Plan will also be the key tool to show the intended Successor that the firm is worth investing in.

In the case of an MBO it should justify the price at which the intended successors are being expected to put “skin in the game” and it should show them their hard work and effort during the transition will leave them with a firm that is worth owning into the future.

In the case of an EOT it should give the proposed directors and trustees confidence that they will be taking control of a proper business which will enable them to fulfil their legal duties. It should also show them and the staff how long it will take to pay out the Retiring Principal and at what point and extent to which they can expect to start sharing in profits.

From an external perspective the critical audience is probably any debt funder in the case of an MBO because they will want to establish that the firm can afford to take on the proposed debt and there will be no difficulty servicing it during the proposed term.

In a worst case scenario, the plan will also enable the funder to establish the likelihood of default and what security may be available to them in terms of the firm’s assets if they need to foreclose.

The plan will also be important to other parties too, potentially it could be used to support and justify the price at which shares are exchanged if HM Revenue & Customs require that. It will undoubtedly be required by any lawyer or accountant who is advising any of the parties involved.

A static Business Plan is of very limited value. If is going to be effective the plan must be viewed as a rolling document.

A properly drawn one will look ahead in detail for at least 12 months and then for a at least a further 4 in summary form.

As each year comes and goes the next year’s plan needs to set out in detail and another one needs to be tagged on in summary at the end.

Furthermore, it is very rarely the case that even the best laid plans stay on track all the way through the process. So it is equally important that progress against plan is regularly reviewed to establish where and to what extent reality is diverging from plan, and so that the action required to get things back on track needs to be both identified and taken.

11.2 The Composition of a Business Plan

Building a Plan should be a gradual systematic process which begins with words rather than figures. The starting point is to sketch out an overview of the firm, to summarise its long term mission and key objectives and the time horizon over which it aims to achieve them.

From there more detail can be added to summarise how the firm is currently positioned and where it is starting from in terms of:

- Service Offering – the firm's regulatory status, current service proposition and current fee structure.

- Locations & Area – where the firm currently operates from and the geographical area over which it currently offers its services.

- Client Base – who, in general terms, it currently offers its services too, how many clients it currently has, current average longevity of clients, current client turnover (ie comings and goings), current average fees.

- Income Streams – the most crucial one is obviously current recurring fee income but the level of new fees generated over recent years is also very useful information.

- Cost Base – the costs which are currently incurred in running the firm broken down into staff costs, fixed overheads (ie long term commitments such as rental contracts & leases and regulatory costs which cannot be avoided or changed) and variable overheads (those costs which can be controlled and which in theory the firm could survive without incurring).

- Personnel – who is currently involved in the firm in terms of leadership, fee earning and supporting operations, a structure chart is a good idea

From the perspective of a Regulated Firm the FCA also expects the Plan to include an overview of the firm's Governance arrangements including a brief resume setting out the background and experience of each Controller and anyone performing significant controlled functions, a structure chart showing the key staff and the roles they perform and details of any areas of the business which it is proposed will be outsourced including the rationale behind such decisions, who it will be outsourced to, how and why they were selected and how the firm proposes to oversee their activities.

Logically it then also sensible to set out not just where the firm is in relation to these factors but also to give some idea of where it sees itself heading in terms of these factors and variables, over what sort of time frame it expects to effect any changes and what effect it expects any proposed changes to have on the firm's financial position.

In this regard objectives must be quantified as far as possible in order to make them real, measurable, and achievable because, if objectives are not clearly expressed, they are more difficult to aim at and becomes very difficult, if not impossible, to understand whether they have actually been achieved.

The often quoted acronym SMART holds good, the objectives set out should be:

- Specific
- Measurable
- Attainable
- Relevant
- Timebound

Once the starting point and the target end objectives are known, a Gap Analysis, a detailed plan of action and a proper Financial Analysis need to be added to complete the Business Plan.

If it is going to fulfil its purpose, the resulting document should be of a reasonable size probably no more than 20 or so pages it should be set out in a logical order and be free of jargon and easy to read.

The Gap Analysis, the Action Plan that falls out of it and the Financial Analysis are totally interdependent, and each has a direct and immediate effect on the other. Because of that they should not be complied as a series of discrete steps one after the other, they should be complied and adjusted concurrently. But for practical reasons it is necessary to start somewhere, and the Gap Analysis and Plan is the logical place to begin.

11.3 Gap Analysis & Action Plan

The idea behind a Gap Analysis is that it analyses the gaps between where a firm currently is and where it would like to be in terms of the various SMART objectives (Service Offering, Locations, Client Base, Financial Position and Personnel) and where it wants to be.

The Action Plan then sets out the steps the firm will take, who will take them and over what time period they will be taken in order to close those gaps. Broadly two elements will be involved in that Action Plan.

The first which is a Marketing Plan is aimed at generating income and the second is a Resource Plan, which is aimed at ensuring sufficient resources are in place to support the Marketing Plan, whilst also ensuring the firm is not over resourced and thereby incurring unnecessary costs.

The Marketing Plan is all about generating fees because fees are, after all, the lifeblood of any financial advice firm. The emphasis should obviously be on new fees but one advantage that firms in this sector have is that a new fee will more often than not lead to an ongoing one This is because common sense and good practice dictate that a client’s financial plan is kept under review but also because the FCA pretty much requires that it, and the products used to implement it, are too.

The Business Plan Summary should have identified the firms service offering and target market, the Gap Analysis should have identified where the firm is and where it wants to be in terms of both. The Marketing Plan sets out how it plans to get from one to the other.

Fee income is a function of (a) the average new fee which is charged and (b) the number of times which it is charged. The Marketing Plan needs to consider both, and the SMART objectives should therefore define both the target number of clients it is aiming at and the average fee it expects to charge, both on an initial and an ongoing basis.

The rest of the Marketing Plan is basically all about defining what strategy the firm will adopt to generate the required number of clients who will be happy to pay the required average fee. Obviously, a whole range of different options are available, including for example:

- Referrals from existing clients
- Social Media
- “Find an Adviser” websites
- Professional databases
- Buying leads
- Webinars & Seminars
- Advertising
- Advertorial
- Professional connections

Equally obviously it is down to each firm to choose whatever strategy, or combination of strategies, it thinks will work best and most cost effectively. Each strategy will involve different resource and cost implications, and each must be fed through to both the Resource Plan and the Financial Analysis so that feasibility can be checked from those perspectives before any plan is put into action.

The Resource Plan is about ensuring the firm has sufficient resources in place both to implement the Marketing Plan and to look after both the current client base and any new clients which are generated effectively and efficiently. Ideally it will ensure that the firm is adequately, but not overly resourced because the latter will obviously result in costs being incurred unnecessarily.

The critical, and by far the most expensive, resource which any firm requires is staff. Staff are also the most difficult resource to obtain and potentially the most difficult one to retain and obviously, in the context of an IS, having staff, particularly staff who are capable of taking over and running the firm, is absolutely vital.

The type and number of staff required, and the skills attributes and experience they are required to possess, will obviously be determined by the firm’s service offering, its geographical coverage and the number of clients it has and is expecting to attract. The cost of the staff will obviously be dependent on exactly the same factors.

Obviously, the number of new clients is a bit of an unknown and so is new fee income.

The firm's most important income stream is its recurring fee base. Critically, if it is percentage based and therefore driven to a large extent by the performance of underlying investment markets, it can yoyo upwards and downwards in an entirely uncontrollable fashion. Many firms simply seem to ignore this point and hope for the best, that can be extremely dangerous, particularly where relatively high staff costs or, indeed, overhead costs which are fixed in nature are involved.

Other crucial factors, pretty obviously, are that once recruited it can be extremely difficult and costly to lose staff who either don't perform to expectations or turn out to be surplus to requirement, that competition for good quality staff is usually pretty intense and that generally speaking staff will expect a pay increase every year. Given that client experience and service is going to be critically important it is probably best to err on the side of caution and over, rather than under, resource from a staff perspective.

So, for all these reasons the level of staff resource required needs to be very carefully thought through and the financial implications need to be properly assessed before any further staff are recruited. It is also important that because good quality staff cannot be recruited without time and effort that the Resource Plan continually looks ahead and ensures any gap in staffing is identified in good time.

The rest of the Resource Plan, because it relates to non human resources that can be fairly easily sourced and, as long as no long term contracts are involved, relatively easily shed, probably does not require as much detailed consideration.

11.4 Financial Analysis

The Financial Analysis is where the Objectives and the Plan to achieve them are quantified and combined into what might commonly be called a Budget.

A Budget is a set of interconnected and interdependent financial statements and workings to support how the figures set out within them have been derived. In order to provide properly comprehensive information, the suite of financial statements must include:

- A Profit & Loss Account
- A Balance Sheet
- A Cashflow Statement

All 3 of these statements must be properly integrated because each of them flow into each other and figures in one will therefore be driven by assumptions and calculations made in the other.

Any change to a figure in one statement will very definitely mean that changes will occur in the others. So, if they are produced individually there is a great deal of scope for inaccuracy to creep into the calculations. The best way to produce a Budget is either to use proprietary software to do it or to design a set of properly interconnected spreadsheets, doing that requires a certain degree of competency in using whatever spreadsheet software is used.

The Profit & Loss Account (P&L) summarises the firm's incomes and the costs which are incurred in generating that income over a period of time. The usual format for a Budget in the context of a Business Plan is to set out the P&L on a month by month basis with an additional column of figures showing the total of each income and cost line for the year. Given the future is unknown it is usually appropriate to set out just the first 12 month period in full detail.

In a financial advice firm, the two key incomes will be new fees and recurring fees and of these the latter is likely to be the largest and therefore most important.

Forecasting recurring fees is very easy if the fees are time based or fixed, it is very much more difficult if they are percentage based because no one knows whether the investments that drive the fees will go up or down over the next 12 month. The best starting point is probably to consider the fees earned over the last financial year and assume they will remain unchanged in the certain knowledge that they won't. Assuming consistency is just a very simple approach which is hopefully a reasonable approximation of how the ups and downs of investment markets might average out of the period.

The new fee target flows out of the marketing plan, it is a simple calculation which multiplies the expected average new fee by the number of new clients which the firm expects to attract.

The budget for staff costs and overhead costs is calculated on a line by line basis looking at the cost incurred over the last 12 months and adjusting it for any changes identified by the Resource Plan and by any inflationary increase which is expected to apply in the current year.

The starting point is to ascertain the firm's current resource and cost base by looking at the latest available accounts and reviewing each line one by one to establish what resource may need to be added, and also whether any can be feasibly be reduced.

In the context of an IS, one overhead cost line which will certainly have to be built from scratch is professional fees. Those will undoubtedly be incurred at some stage in the process and in a reasonably significant amount.

Considering the significance of staff costs and the fact that most, if not all, staff are directly involved in generating income, a sensible way to present a Profit & Loss Account for most IFA firms is as follows:

		£	**%**
	New Fees		
plus	Recurring Fees		
plus	Other Income		
equals	**Total Income**		**100**
less	Staff Costs		50
equals	**Gross Profit**		**50**
less	Overhead Costs		20
equals	**Operating Profit (EBITDA)**		**30**
less	Financing Costs		x
less	Accounting Adjustments		x
less	Distributions		x
equals	**Retained Profit**		**x**

Note the emphasis on identifying EBITDA, which was referred to as the most common Performance Factor used as the basis for valuing the firm.

Not many firms will have other income but anything other than client fees should probably be recorded separately to make it easier to interrogate the figures and to track performance against the Marketing Plan.

The idea behind the Business Plan P&L is to check that implementing the plan will result in the firm making a profit (ie that the income it makes will more than cover the costs that in incurs).

It is not absolutely imperative that a firm makes a profit, and very often they don't in their first couple of years of operation or during periods of fairly rapid growth when costs may deliberately have been increased in the short term.

But no firm can continually run at a loss, if it does it will inevitably run out of cash, fail to meet Capital Adequacy requirements and crease to trade.

So, it is very important that whatever else it achieves, a Business Plan ensures that the firm will become profitable within a reasonable period of time and continue to generate profits long term. If it doesn't the firm has little value from the Retiring Principal's perspective and there is no incentive at all for any Internal Successor to buy out their interest and take over the firm. A firm in that position would only be of interest to an external purchaser which wishes to acquire the client base and consolidate it.

The percentages which are set out above are my view on what a sensible staff cost, overhead and operating profit ratio should look like in order to ensure staff are paid reasonably well, overhead costs are controlled and a reasonable operating profit results. I believe that an efficiently run firm, and one which is seeking to sustain itself long term, should be aiming to keep Staff Costs to no more than 50% of total income and Overhead Costs to no more than 20% so leaving an Operating Profit of 30%.

That Operating Profit can either be distributed to the business owners or retained and reinvested in the business. Generally, it is sensible ensure some of it is retained so the firm has some amount of in reserve to see it through any adverse trading conditions or downturn in business. A growing firm will undoubtedly need to incur costs, meeting those will restrict the amount which can be immediately paid out to shareholders. There is a real balance to be drawn between receiving more cash today or applying it to fund growth and build future profitability as far as they are concerned.

One cost line which it is appropriate to highlight and sensible to segregate in an IS situation is Financing Costs. These are not a normal overhead in that they don't relate to the day to day trading activities as other overhead costs do, they are a function of how the firm is financed.

In the case of an MBO it is invariably the case that the IS transaction will be partly financed by debt and segregating the cost of incurring and servicing that debt (basically arrangement fees and interest cost) will enable both the owners of the business and the external financiers to quickly and easily ascertain the effect of the borrowing on profit, and to judge whether the firm can incur the cost of servicing it without any difficulty.

Accounting Adjustments are of no real practical concern, these are simply adjustments which may be required to ensure the published Accounts comply with company law and accounting standards. There are however of practical importance because they must be deducted from profits to define exactly how much residual profit is available for distribution to the owners. If the firm doesn't employ a qualified Accountant calculating these adjustments will probably require professional assistance.

The Balance Sheet (BS) is effectively a snapshot of the firm's financial position at a single point in time.

It shows the firm's assets (what it owns), and its liabilities (what it owes) and the difference between the two, which is effectively the book value of the company as explained in Section 10.

It is known as a Balance Sheet simply because what its Book Value is a balancing figure:

What it owns – What it owes = What its worth in Book Value terms

Obviously Book Value could, in theory be a negative figure, but if it is that suggests the firm might be in a rather precarious position and probably does not have much intrinsic value, at least not to an Internal Successor. A negative Balance Sheet might mean that an IS will not ultimately be feasible and an External Sale will be a far more sensible approach.

The BS then goes on to show how the book value position is financed whether that be by capital subscribed by shareholders, by reserves which the firm has built up through its trading activities or by borrowed money in the form of debt finance.

Essentially the BS enables investors, lenders or any other interested party to judge a firm's financial health at the date that it is drawn up.

Because it differentiates between short term assets and liabilities (ie those that will be crystallised within the following 12 months) and long term ones (which will crystallise over a longer period) the BS can also assist judgements in relation to the company's liquidity position, its solvency and, particularly when it is read in conjunction with the P&L, whether any financial difficulties are likely to arise in the foreseeable future.
Following on from that, the it also helps judgements to be formed about whether the firm may need anyone to inject any cash to ensure it can carry on trading, how much risk might be involved in providing that finance to it and, therefore what sort of return the party providing it might sensibly expect and require to compensate it for taking the degree of risk involved.

The Cashflow Statement (CF) forecasts how much cash is going to flow in to the firm from the fees it earns, how much cash is going to flow out as it continually has to pay its staff, its other trading expenses and any financing costs, and therefore what the net cash position is expected to look like over the Business Plan period.

Profit and Cash are two very different things. In order to flourish in the long term a firm has to make both but in the short term although it can survive for a while without making profit, but it cannot survive without cash.

In the context of a financial advice business profit arises when the fee income it generates exceeds the trading expenses and financing costs which are incurred in the process. If all clients paid fees instantaneously and if all expenses were paid instantaneously profit would equal cash, but this will never be the case.

No clients pay straightaway, if fees are invoiced it is usual to offer the client at least 30 days to pay and anything less could smack of desperation.

Even if such terms are offered some clients will take a lot longer to pay, particularly if there is any dispute about the fee or the quality of the service provided. Some clients' cash might simply be tied up, for example there might be a delay in paying until a property has been sold. If fees are paid through investments, there will always be a lag of at least 30 days and depending on terms of the Agency Agreement, the delay could be up to a year.

If commissions are earned on insurance or mortgage related products payment will follow hopefully within 30 days of completion, but if commission is on an indemnity basis it might have to be repaid and the full amount received can't be counted as income until the indemnity period has expired.

On the other hand, staff want to be paid every month as do most of the trading expenses. FCA fees and indemnity insurance can usually be arranged in instalments, but staff won't wait to be paid and nor will most trade suppliers or financiers. Some major expenses such as the firm's annual tax bill will probably be paid in one amount each year, other tax bills such as VAT will be paid quarterly but payroll taxes have to be paid each month.

So, there is always a difference between Profit and Cash, and this is why a Business Plan must include a Cashflow Forecast.

Even if a firm produces very good profits, if it doesn't collect what it is owed in a timely way, or pay what it owes in accordance, by the date required, it could be put out of business within a very short space of time indeed.

11.5 Building the Budget

Faced with the 3 different, yet interconnected and interdependent financial statements required it is necessary to start somewhere.

Anyone with reasonable spreadsheet capability should be able to construct an integrated Budget using that kind of software. There are also plenty of Business Planning software packages available to assist in the process. Obviously any third party accountant who advises the firm in relation to annual accounts or tax matters would probably be well equipped and absolutely delighted to help produce a Budget if requested.

The best place to start as regards the figures will be the P&L and the cost base of the firm.

Obviously, all firms know who they employ and what salaries and other "on costs" such as National Insurance and Pension Contributions are involved. Let's call this figure SC. Assuming the IS can be facilitated with no changes to Staff or Staff Costs then the only adjustment required is to build in the adjusted inflationary or merit increases etc which are expected over the next 12 months.

Most firms should also have a very good idea of what other expenses are incurred in running their business, let's call that figure for total expenses TE. If a firm doesn't know its TE, the starting point is that it really needs to because no IS can sensibly progress until it does.

The current TE figure might need to be adjusted to take account of any changes in the type of the amount of each expense which are envisaged over the next 12 months, it is very likely that progressing towards an IS will increase some costs, it may very well also reduce others.

Knowing costs then facilitates a calculation as to what level of income will be required in order to cover those costs and produce the amount of Operating Profit (OP) required over the next year.

As set out above, a well run firm should aim to maintain SC at around 50%, TE at around 20% and therefore OP at around 30%. A firm making this level of OP should have no difficulty at all in seeing through a successful IS, it should be a very attractive proposition for both the successors and for any debt financiers who might need to be called upon.

If the OP is substantially lower an IS may well still be feasible, but it might be a little more difficult to achieve. An OP of 10% or lower probably suggests an external succession might be the more appropriate way forwards.

The next stage is then to look at what income is currently being received. Obviously, the number of new firms a client will attract over the period of the Plan is an unknown, but all firms should have a pretty clear understanding of their ongoing, recurring fee base (RF). Again, if they don't, they really do need to get one before going any further.

The extent to which RF can be predicted obviously depends upon the particular fee structure involved. Obviously if the firm charges percentage based fees which are dependent upon the value of its clients' investments it is impossible to predict what the figure might be over the next year with total accuracy, because the value of those investments will obviously rise and fall. On the other hand, if a firm has agreed fixed fees with all its clients those fees can be predicted with almost total certainty, accepting obviously some client accounts may close for reasons of death dissatisfaction relocation or some other factor.

Most firms will be somewhere in between these extremes when it comes to ongoing fees, but the Business Plan requires a sensible estimate to be made, at least on a provisional basis.

Once recurring fees have been estimated the level of new fees (NF) required to achieve an OP of 30% simply becomes a balancing figure.

Simple algebra means that as soon as 4 of these figures are known the fifth one is immediately apparent:

$$NF + RF – (SC+ TE) = OP$$

Obviously, the calculation may not produce the desired result, and very often it won't.

Particularly in smaller firms it may be difficult to keep TE down to 20% of income, SC is pretty much fixed at whatever the current level is because it is difficult to make changes to either staff or salaries.

Some firms may already be in the very fortunate position that they generate an OP of 30% simply by looking after their recurring fee base and with no need to generate any NF. But even firms in that position should not be complacent in the context of an IS because RF will naturally decline over time and, particularly if a fee base is percentage based, falling investment markets can have a very short, sharp and very significant effect.

Essentially building a Budget in this way starts with the knowns (the costs) and builds up estimates of the unknowns (the incomes). The aim is to simply to identify what level of NF is going to be required to generate a reasonable OP of between 20% and 30%.

And then it moves on to considering whether that NF target will be feasible over the period of the Business Plan, which will be at least the next 12 months and at most the period until the Retiring Principal wishes to retire.

If it is thought to be feasible the next step is a detailed analysis of what average fee is planned and how many times the firm plans to charge it accompanied by a detailed Marketing Plan which sets out some SMART objectives, the actions which will be required to achieve them, who is going to take it and by when.

Obviously the other alternative, if the NF target is thought to be infeasible, is a detailed review of costs to see how feasible it might be to bring OP back to within reach of 30% by reducing any of them. This is where for example outsourcing some functions or changing working practices could have the desired impact on OP within an acceptable period of time.

The reason why OP is such an important figure is it should be the immediate focus of any Internal Successor because it will show them:

(a) whether the Retiring Principal's valuation is reasonable, as set out in Section 10 and

(b) what level of baseline profit they may expect in future.

It will also be an important figure for a debt financier in an MBO because it is a major consideration in establishing a firm's ability to service debt. It is also crucial to all parties in establishing how long it is likely to take before the Retiring Principal can be paid out in full for their interest.

The forecast P&L should be produced on a month by month basis because income and some cost figures will undoubtedly vary on a month by month basis. Once the forecast P&L has been produced it is a relatively simple process to produce an accompanying month by month CF by applying some assumptions as to what timescales it is expected that clients will pay their fees and with what frequency the firm will have to pay each of its various costs.

The P&L and the CF will then need to be fed through into the integrated BS. The opening balances for each account will be taken from the latest available accounts and as long as the various statements are properly and accurately integrated, which is where proprietary software of the firm's accountants may come in, the BS will simply flow out of the other two statements.

The 3 statements which comprise the Budget will, together, establish whether an IS will be feasible, the valuation on which it should be acceptable to all parties (including HMRC and financiers), the period over which the transaction can sensibly be completed and broadly what the firm's financial future should look like.

Assuming it gets the go ahead from both the Retiring Principal and the Internal Successor it will also then enable the parties to move to drafting the Sale Contract and arranging any finance required. Once the financing costs are known with certainty the Budget can be updated to ensure complete accuracy on those and the final version can be signed off by all concerned.

12. Implementation of the Business Plan & The Transition

Once both the Retiring Principal and the Intended Successor have agreed the Business Plan it is sensible to flush it out into a detailed Internal Succession Plan.

This will set out all of the actions which are going to be needed to bring the project to a successful conclusion, the actions that are going to be required, who is going to be responsible for taking them, the order in which they need to be taken and the timeframe within which they have to be taken in order to bring it to a successful conclusion.

As with the Business Plan, there also needs to be a formal process to ensure progress against the ISP is kept under regular review so that any divergence from it is identified at an early stage and the implications can be assessed. Obviously also this process needs to consider whether the plan needs to be adjusted and what action should be taken to get the project back on track.

The detailed Plan will need to consider broadly the same factors which were considered during the IFS, but they now need to be considered in more detail. The fact that more people are involved will also enable the responsibility for implementing the ISP to be shared and amongst other things that will hopefully result in a smoother, more efficient and more timely transition so that any short term impact on the business itself is kept to an absolute minimum.

Sensibly the detailed Internal Succession Plan (ISP) will again be broken down into various headings:

12.1 People

This aspect of the ISP will sensibly ensure that the proposed transaction and the ISP are explained in detail to all staff at a very early stage in a very clear way. This is because if there is going to be any uncertainty or concern about the plan the earlier it is identified the better.

The more time people have to discuss any concerns the more likely it is they can be addressed and, furthermore, those discussions could mean it becomes appropriate to adjust the ISP in some way. Changes later down the line are likely to cause more disruption that necessary so getting the ISP right from outset is the best way.

The ISP also need to ensure there is a formal process to ensure colleagues are kept up to date with how the transition is progressing, that they are invited to ask any questions or express any concerns that they may develop along the way and that there is a very clear process for considering any which arise and responding to them appropriately.

It is imperative in this regard that both the Retiring Principal and the Internal Successor are totally united in any views which are expressed and the way in which they are expressed.

Anything else is likely to either blur the message or distort it and in either event the message will lose clarity and impact. At worst it could cause a lot of disquiet and disruption. The people who staff the firm are, after all, second only to clients in their importance to its future success. If any of them become at all disgruntled or unnerved by the transition process the effect could spread quite quickly and the disruptive effect could be significant.

Crucially this aspect of the ISP is also about identifying any potential skills and experience gap and then plugging it. It is really important to ensure that, by the completion date, the Internal Successor is fully equipped with, or they have access to, all of the skills and attributes they need to take over the control and management of the firm, its clients and the staff involved because, if they are not, difficulties will probably arise very soon after the Retiring Principal leaves the scene.

At worst such difficulties could totally defeat the object of the IS if the firm falls apart. It could obviously therefore also compromise the payment of any deferred consideration which is the Retiring Principal is due to receive.

So, the starting point is to establish what management and client facing roles the Retiring Principal has been performing, what particular skills, attributes and experience have been required to perform them and whether they are also held by the internal successor. If they are not then there needs to be a plan of action which will either instil them, or ensure they are accessed externally, by the time the IS will complete.

Many of the gaps that may exist can probably be filled by personal coaching and mentoring on the part of the Retiring Principal and obviously they have a direct incentive to provide whatever is required. But some such as, for example, specialist technical qualifications or knowledge could take time to achieve or instil.

And some, such as the respect and trust of clients, colleagues or professional introducers can't be instilled, they must be earned. Obviously, a personal handover of relationships will greatly assist in the process if it is done properly. On the other hand, doing it quickly, or abruptly, or in a cursory manner is very unlikely to retain the anyone's confidence. Doing it gradually over a period with the Retiring Principal continuing to support from the background is far more likely to succeed.

It is important to remember there are limited hours available in a working week. Handing over responsibilities takes time and there will inevitably be a knock on effect on the business because client handovers will require time on the part of both the Retiring Principal and the Successor. They will therefore have less time available the implications, perhaps particularly in terms of the effect on new business generation, should be properly assessed and reflected in the Budget as appropriate.

The IS could result in a need to recruit new staff, particularly it will if the Internal Successor doesn't already work for the firm. Organising that will also require time and potentially recruitment costs. It may also lead to some salaries and remuneration packages being adjusted, for example there may be some other key staff the successor is particularly keen to retain or incentivise as part of their future plans.

The IS could also potentially result in some other retirements or in some colleagues wanting to leave. This might particularly be the case if some other colleagues are nearing retirement age and see it as a logical trigger for their own exit too.

It may also trigger resignations from others who have a particularly close relationship with the Retiring Principal or have a particularly poor one with the Internal Successor. It might be difficult to assess this particular risk of such disruption in advance, but the point should at least be considered. In most firms where an IS is being implemented, hopefully the Retiring Principal and Internal Successor should, between them, have a reasonably good idea of whether it is likely to result.

Obviously, the Retiring Principal will be leaving or at least changing their role and the level of their involvement. Whatever remuneration and benefits they were drawing will no longer be incurred. The IS will probably mean that a range of remuneration and benefit options become available to the Successor which they were unable to consider before. They may also want to change or introduce the current range of options and benefits available to their colleagues. All these factors need to be considered as part of the ISP.

Perhaps the most crucial decision which needs to be made as regards people is will the Retiring Principal have any ongoing involvement. If they will then consideration needs to be given to what role they will play, what degree of influence they will have, who they will be accountable to and what the terms of their involvement will be, how long will it be for, who will decide when it should end and how will they be remunerated.

In many cases the decision will not need to be discussed or made because the Retiring Principal will be looking forward to a full retirement and will not want any further involvement. This will almost certainly be the case if they have sold their shares back to the firm they almost certainly will not want to be involved because being so would at least double their capital gains tax liability.

In other cases where they might want to stay involved, the discussions can become difficult. The whole purpose of a transition period and a proper handing over of control and leadership is to put the firm in the position where it no longer needs the Retiring Principal to play any role at all. Any role the Retiring Principal does want to play will obviously have to be agreed by the Internal Successor because they will be the new owner.

It might well be appropriate for the Retiring Principal to remain actively involved until they have been paid out in full, they may want to in the expectation it will give them greater visibility over how the business is faring. But any role extending beyond that point would sensibly be questionable. If the Retiring Principal wants anything more than a short term, part time Consultancy role then it would be right to question why they actually want to sell.

In an MBO scenario, the Internal Successor may welcome the Retiring Principal's continued involvement for a period of time because the benefit of their experience could be invaluable. But they should be very reticent to accommodate a long term involvement. If they are not, it is questionable whether they are in fact the right person to take on the role of Successor.

It is very common for the Retiring Principal to retain longer term and more substantial involvement in an EOT scenario, particularly if it was only a partial sale and they continue to hold some shares.

The Retiring Principal could be an ideal candidate to perform the role of trustee, particularly if they are no longer involved in leadership and management because that could enable them to act as an employee champion with a more independent voice. In this context though, it is very important to remember HMRC's current Consultation. If the Retiring Principal has too much ongoing involvement in the running of the firm, and the directors and trustees do not have enough, this could lead HMRC to question whether the EOT is properly able to fulfil its purpose or whether the transaction complies.

Whatever the route taken to IS, it is vitally important that if anyone envisages the Retiring Principal will have ongoing involvement, the nature, breath and period of that involvement is discussed and agreed by all parties at a very early stage. If it is not the potential for misunderstandings and differences of opinions to arise is substantial and in a worst case scenario, they could derail the project completely.

12.2 Operations Systems & Processes

An IS will be very likely to have at least some impact on Operations Systems and Processes in the longer term, particularly if the Internal Successor has their own ideas as to how the firm should be run.

It is probably fair to say, for example, that Advisers who have entered the profession more recently have greater awareness and experience of modern IT systems and computer packages and how they can be integrated to fundamentally change the way a firm conducts business. It's probably also fair to say they often have greater enthusiasm for taking on the challenges and costs involved, than would a Retiring Principal who is coming towards the end of their career.

If the proposed Internal Successor doesn't have some ideas of their own, it could be questionable if they are actually the right successor. Financial Advice firms operate in a dynamic environment and, although change for change's sake is not usually a good idea, constantly reviewing systems and processes and considering whether they can be improved very usually is. Arguably it is an essential element of building and maintaining a successful, reasonably profitable firm.

The key question to consider is whether on balance it is better to implement any foreseeable changes in one go whilst the Retiring Principal is still involved, on the basis that although may create more upheaval during the transition it will get it out of the way, it will give the Internal Successors a better base and it will enable them to focus their efforts on clients and building the firm. Or is it better to keep change to a minimum at this stage, focus solely on the transition of ownership and control and leave the Internal Successors to implement whatever changes to systems and process the envisage in the fullness of time.

Bot approaches have their own advantages and disadvantages. Change inevitably involves cost and cashflow implications and an assessment of those is obviously a key element of the decision. It will be down to the parties to assess which way works best for them considering the specifics of their particular firm, their staff and their client base.

It may be better to complete all the changes envisaged while the Retiring Principal is on hand to act as a champion and a support, rather than leave the

Internal Successor to do introduce them at a time when they also need to focus on clients and other key business relationships. It could also be that IFS have identified the need or the advantages of updating technology, streamlining systems and processes, introducing fresh ideas, or perhaps outsourcing some functions or bringing others back in house in which case it might equally be sensible to get on with effecting those changes as soon as possible.

12.3 Compliance

An IS will require some detailed input from the firm's Compliance Adviser to ensure that all FCA requirements are met continually both throughout the transition phase and into the future post completion.

Almost inevitably the Retiring Principal will have been performing various FCA Controlled Functions which relate to the carrying on of regulated activities by the firm. The two key ones are likely to be:

- CF10 Compliance Oversight
- CF11 Money Laundering Reporting

It probably goes without saying, but for the sake of completeness it is important to note that, for the firm to continue post completion it must also have at least one person performing the CF1 Director role (or the equivalent in the unlikely event it isn't now structured as a company, and at least one Adviser holding the CF30 Customer function.

It is vitally important to ensure someone is appointed to take over any CF functions which are held by the Retiring Principal and that they are in post by the date at which the IS completes. If all the required functions are not continually fulfilled by someone the firm will be in breach of FCA rules.

The other crucially important aspect from a compliance perspective is that Part XII of the Financial Services and Markets Act 2000 requires controllers of a regulated firm to seek approval from the FCA before they take over control and it makes it a criminal offence if they fail to do so.

An IS will inevitably involve a change of control but, in the very unlikely event it does not, it is also important to note that an authorised firms also have an obligation to inform the FCA of any changes at all to the control structure of a firm as set out in the FCA Handbook SUP 11.

The procedure for notifying the FCA is relatively simple. It requires completion of a Change in Control Notification Form (also known as a Section 178 notice) and for that to be submitted, together with the specified supporting information, which is required, to the FCA through its online Connect system.

The FCA is then allowed up to 60 days to assess the application and issue its approval or otherwise.

It is highly likely that the firm’s Compliance Adviser will be able to judge whether there may be any difficulty in obtaining FCA approval for a Chage in Control, but it is obviously sensible for the application to be made at an early stage in proceedings so that plans can be adjusted if any difficulties do arise.

12.4 Legal

Obviously, the sale and purchase of the firm is a very significant event and will have very significant financial consequences for both the Retiring Principal and the Internal Successor.

It is therefore equally obvious that both would be best advised to take their own legal advice and that the transaction is enshrined in a contract which ensures all parties understand exactly what transaction they have committed to. It is also likely that a range of other legal documents will flow from the IS transaction, each will take time to draft, to check, to discuss if necessary and to approve and significant costs are likely to be involved.

Whether the documentation is drafted by the seller, or the buyer is of no practical consequence but, given the Retiring Principal’s adviser, who may well also be the firm’s adviser, will probably have been consulted by them at a very early stage and will have a good understanding of the firm, they may well be best placed to do it most efficiently.

The Sale Contract itself cannot be drafted until all of the relevant terms have been agreed by the parties involved and that probably cannot be finalised until the Business Plan and the ISP have been agreed.

Given that all parties will be committing time effort and cost to bring those to life it is not unreasonable for them all to require proper comfort that they are agreed in principle on how the transaction will proceed.

So typically, the first document which will be produced is a Heads of Terms (“HOT”) which set out the key terms of the proposed transaction, for example the proposed parties, the proposed price and the proposed timeframe. It may also set out certain other obligations, principally in relation to confidentiality and it will usually also impose a period of exclusivity which will tie in both the Retiring Principal and the Internal Successor for a period of time meaning the Retiring Principal cannot negotiate a sale with any other party, and the Internal Successor is precluded from taking up any other role for a period of time, or until the IS is concluded.

The HOT is not a Sale Contract and neither side will be able to rely on it to force the IS through. It is though a serious formality through which both parties’ express clear intent and commitment to achieving the deal on the terms set out. It should, amongst other things, give a proper structure and framework to the prosed transaction and it should make drafting the Sale Contract itself a much easier task. Crucially it gives all parties formal confirmation of the proposed terms and the timeframe at an early stage and before too much time effort and cost is expended on the project.

A whole range of other legal documents is likely to be required and each one will need to be drafted, discussed, agreed and completed. In addition to the Sale Contract and depending upon the nature of the proposed transaction there may also be a need to produce an Employee Ownership Trust Deed, a Shareholders Agreement & Service Contracts for the new Directors, and it might be appropriate to produce a summary of the responsibilities involved to assist anyone who is unfamiliar with the role they are going to perform. It might also be necessary to produce a Consultancy Contract of the Retiring Principal is going to perform an ongoing role.

It will also be important to review all the contracts which currently exist between any of the parties involved and the firm to make sure that the IS and any new contract will not compromise anyone’s obligations under those. It is probably also sensible to ensure all existing contracts are properly terminated as well, just to ensure that no problems with those can arise in the future.

If the Retiring Principal has agreed to defer payment of part of the consideration which they are due for their shares they will sensibly want to protect their position in the event the IS fails to deliver the payments as agreed. Some of the contracts will impose potentially onerous personal obligations, for example personal guarantees or other similar clauses. It is therefore imperative that that the schedule for producing the legal documentation ensures sufficient time is made available so that each of the parties involved can take whatever legal advice each of them feels is appropriate before they sign to accept the terms.

The final aspect of the legal formalities will, assuming the firm is now structured as a company, will be ensuring that all the requirements of company law are observed and that all the required documents and updates required are filed at Companies House.

12.5 Other Considerations

Brainstorming the ISP and keeping it under regular review will hopefully ensure that it identifies and addresses all of the key tasks which will be required to achieve a successful transition, but it is perhaps worth specifically highlighting a few critically important points to ensure they are not overlooked.

The first is to ensure that Professional Indemnity Insurers are advised of the plan at an early stage to check whether they think the proposed transition may cause any difficulties or affect the firm's premium in any way.

Following on the insurance theme, obviously the IS will take some time to implement, and it is entirely possible that any of the parties could suffer a personal catastrophe during the transition phase. Depending on the nature of the IS one of those could totally derail the transaction. It is therefore very sensible to consider the range of possible scenarios and the implications thereof, again at an early stage, and to consider what action, or possibly what insurance cover, might be appropriate to reduce either the risk or the impact involved.

The point regarding insurances also flows through post transition. It will obviously be sensible to review any protection policies which the Retiring Principal has set up, particularly if they are paid for through the business. Obviously there will probably come a time when that cover ceases to be relevant, equally obviously it might be sensible to put similar or alternative policies in place to cover the Internal Successor and the effect that a catastrophe befalling them might now have on the firm.

Another very important point to agree is whom will have what authority to make decisions during the transition phase, and thereafter. As soon as the Internal Successor has come on board they will expect, and frankly if they have contributed financially, they have a right, to be involved. The Retiring Principal, if they have chosen the right successor and they have any common sense, should actively welcome their involvement too. It is though sensible to formalise authorities and decision making powers to some extent so that uncertainty and misunderstandings are avoided.

One of the very practical ways in which that division of authority and decision making will manifest itself is the power to incur costs and pay debts. The authority to sign contracts, place orders, recruit staff during the transition phase needs to be carefully considered and formalised. Bank mandates and the limits of each person's authority to make payments needs to be thought about, agreed and communicated to the firm's bankers.

And finally, given that more people are now involved in the leadership and management of the firm, it is also going to be necessary to review the firm's governance procedures and ensure that all legal requirements are complied with in relation to those. Rather than hold meetings to review progress against the ISP, it will probably be more sensible to establish regular board meetings, and trustee meetings if appropriate, and to incorporate the review progress against the Business Plan and the ISP as an Agenda item for those.

12.6 Critical Path & Timeframe

When all the tasks required to implement the ISP have been understood and set out it makes sense to also identify the Critical Path on which they need to be completed (ie the order in which each task needs to be completed, which ones can be completed concurrently with others and what date each task needs to be completed by).

Obviously, to ensure that implementation happens in a controlled fashion, it is also necessary to allocate the responsibility for completing to an appropriately qualified and experienced member of the team. It is also very sensible to establish a forum which will keep implementation of the full plan under review and take whatever action is required and appropriate to keep it on track.

12.7 Finance

There is no doubt any lender will require regular updates on the firm's financial performance so that it can check whether any difficulty in it meeting its financial commitments is likely to arise. Sensibly any Retiring Principal who has not been paid out in full will also require them for exactly the same reason. Without doubt the Internal Successor will want to know whether the plan is on track and if an EOT is involved then so should the trustees and possibly the eligible employees.

So, from a financial perspective the ISP has four key objectives in an MBO situation:

1. Explaining the firm and its plan is sufficient detail to any proposed financier in a form which they will understand, and which will present the scenario as an attractive lending opportunity and ensuring that either funding is in place at completion date, or that if it is not the terms of the IS have been adjusted and re-agreed to take account of that.

2. Ensuring that the firm's financial position is kept under regular review, that any divergence from the Business Plan becomes quickly apparent, that the implications of that divergence can be assessed and that, if they are material, that actions are agreed an implemented to get the finances back on track.

3. Reviewing the Funding Gap, which is the difference between the price at which the Retiring Principal has agreed to sell their interest, and the amount of cash which the Internal Successors and/or the firm is going to be able to contribute from their own resources, without compromising the business' ability to meet its working capital requirements. The original Funding Gap is very likely to change if the Business Plan as originally envisaged is not achieved. It is important that any potential change is identified as soon as possible so the implications can be considered.

4. Reviewing exactly how the Funding Gap is going to be bridged, which will be by a combination of external borrowing, or extending the time period over which the Retiring Principal receives payment in full, or a combination of both. Again, any change in the Gap might require a rethink as to how it is going to be bridged.

The underlying Business Plan is obviously crucial to the achievement of these objectives. It is also going be critically important in ensuring that that sufficient profits are generated to service any debt and to make sure the Retiring Principal gets paid in accordance with the contracts that have been made.

The quicker any divergence in financial performance is identified the better because the smaller the gap will be and the easier it will be to close. The longer the delay in identifying it the bigger the gap will be, and the more drastic the action required to close it will be.

So, the root of financial control is sufficiently comprehensive and timely management information, predominantly as regards income generation and day to day spending. If the firm doesn't produce them already, it will be vitally important to ensure that sufficiently clear and informative management accounts are produced and circulated to all the parties concerned, as soon as possible after each month end.

Those monthly accounts would sensibly include a detailed P&L, showing new and recurring fees, staff costs and a line by line summary of each individual overhead cost, and BS Balance Sheet summarising the firms up to date position as regards assets and liabilities. As long as incomes and costs remain on plan, fees are collected promptly, and expenses are paid on time the cashflow should just fall into line and a formal monthly CF statement should not be required. If those variables so begin to diverge materially from what was expected in the plan it might though be sensible, or indeed vitally important, to have a detailed look at the effect of that on cashflow.

Both financial statements should include a comparison against Budget and any key variances between actual and planned performance should be highlighted with a brief explanation as to how it has arisen and whether any action is required to close the gap.

Either the Internal Successor or the Retiring Principal should be able to call a meeting to discuss any concerns that become apparent and until the Retiring Principal is paid out, they are very clearly entitled for their views to be at least heard.

If things do go off course obviously any external lender, and probably the Retiring Principal too, will have ensured they are in a relatively secure contractual position compared to the Internal Successor. A wise Internal

Successor will therefore want to avoid tempting either of them to enforce their rights under those contracts because that could well mean significant financial difficulties for them personally and possibly the end of the firm. What they should want to do is collaborate with both to ensure the firm gets back on the right financial track and all parties are happy with the way things are going.

13. Merger as a route to Internal Succession

As a final point, it is worth considering that a Retiring Principal might find the concept of an IS attractive but think at first glance it might be infeasible, perhaps because they cannot identify a natural successor, or they feel their firm might be too small to make it work, because they can't make the figures work or they feel a bit daunted by doing it on their own.

One other option which might well address all of those concerns is merging with another local firm which feels the same way, as a step on the journey to the final destination.

Obviously a very easy option might simply be to sell out to a third party Consolidator but doing that will result in the Retiring Principal losing all influence over what happens next to their Clients and their Staff.

Merging two smaller firms to create one bigger one may require the owners of each firm to compromise but it will also undoubtedly enable both to retain a lot of influence and to share control between them.

Merging two likeminded firms can produce a raft of other benefits too, for example:

- It is also rarely the case that one individual gets everything right all the time. Almost certainly sharing thoughts and views will germinate fresh ideas. Combining knowledge, skills and experience can lead to a more comprehensive service offering and better outcomes for clients. Spreading the load of leadership and management can reduce stress levels and make life far more enjoyable.

- Building critical mass will no doubt increase negotiating power with product providers, investment managers and suppliers potentially resulting in lower charges for clients and lower costs for the firm. Combining firms can significantly boost profitability.

- Staff may very well feel that a larger firm offers greater security and a more promising career path, not only can this help with retaining staff it can also make it a lot easier to recruit.

- Merging two local firms can be a route to local market domination. If it achieves that it can produce exponential increases in the number of new clients which are attracted to it.

What is likely to emerge from a merger of likeminded firms, one way or another is a larger, is a financially stronger firm which might well be able to offer a broader range of services, and the value of the whole may very well be greater than the sum of the parts. Hopefully such a firm might now be far better positioned to see through an IS when either Principal wants to retire.

Obviously there will be a need for discussion and compromise, there will be a need to place trust in the other party, and certainly a merger is inevitably to some extent a step into the unknown. But, without any doubt, selling to an external Consolidator requires exactly the same.

The big difference is that an external sale means the Retiring Principal will lose all control and is probably left with little or absolutely no influence, and it will be very difficult, if not impossible, to reverse out of such a transaction if it fails to meet their expectations.

A merger, on the other hand, will mean they continue as a Principal, they will retain influence and a share of control and if the worst comes to the worst their co-Principal will probably also be very amenable to putting things back as they were.

Putting two firms together will inevitably increase its attractiveness and its value as far as an external purchaser is concerned so there could be a benefit even if the merger does not create a route to IS. Large Private Equity backed Consolidators might pay up to 4 x EBITDA for a firm which generates an annual profit of £100,000. they will probably pay a multiple of between 6 to 8 times if it makes annual profit of £500,000 or more.

So, in simple terms a smaller share of a larger cake is, in the long run, likely to have a very significantly higher value than a larger share of a small cake, no matter whether the Retiring Principal exits through IS or external sale.

Looked at from that perspective, merging two smaller firms to create one larger one really can represent a no lose strategy.

14. Final thoughts

The objective of writing this Guide has been to raise awareness of IS as an option and to set out, in broad terms, the factors which I think are involved.

My aim is to encourage more Retiring Principals to preserve their firms, avoid disruption for their clients, provide a route to ownership for at least some of their staff and, above all, to help create and sustain a truly Independent Financial Advice profession.

Without doubt, whatever route to succession is chosen there will be a need to consult professional advisers, particularly in relation to the legal and taxation aspects involved. It may also be necessary for some firms to take advice from an accountant in relation to compiling a sufficiently detailed and cohesive Business Plan, and some may wish to engage with a finance broker to engage with potential debt financiers on their behalf.

But apart from those areas where a technical assistance is required, all that is needed is commitment on the part of the Retiring Principal and the Internal Successor, honest and transparent discussions, a spirit of collaboration and compromise, a clear plan of action, probably some external finance and the determination to bring all the elements together and see the project through.

I hope my thinking has stimulated interest in the concept of IS and that I have given any IFA Principal who is considering their future retirement some useful information and food for thought.

I also hope I have been able to provide those who are interested in the concept and want to implement their own IS, a general idea of the framework and the path which I have followed in bringing mine to a conclusion. I would welcome any feedback which anyone would like to offer, whether that is good bad or indifferent.

My retirement from my firm is actually in progress as I write this, and it will happen in 2024. Once I have completed that to everybody's satisfaction, I might be happy to offer some on a part time Consultancy basis if anyone would like any further input or assistance with their own Business Plan or IS project.

I can be contacted at dave@daverobconsulting.co.uk.

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